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[JOINT COMMITTEE PRINT]

PRELIMINARY DIGEST OF SUGGESTIONS FOR INTERNAL REVENUE REVISION SUBMITTED TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

PREPARED BY THE

STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

APRIL 21, 1953

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PRELIMINARY DIGEST OF SUGGESTIONS FOR INTERNAL REVENUE REVISION

Submitted to the Joint Committee on Internal Revenue Taxation

Introduction

The staff of the Joint Committee on Internal Revenue Taxation has been conducting a survey eliciting suggestions and comments from the general public relating to improvements in the internal revenue laws and their administration. This survey has been made pursuant to instructions from the committee to undertake a revision of the Internal Revenue Code. To assist in developing the type of improvements desired, the staff distributed a questionnaire, a copy of which is included in this report as appendix A. The response to this questionnaire was immediate and widespread from all parts of the country. Thousands of replies were received from individual taxpayers, businesses, tax practitioners, various professional groups, and trade associations.

For months the staff has been engaged in studying the many suggestions received. The very magnitude of the response as well as the diversity of the problems raised have precluded the staff from completing its analyses of the various suggestions submitted. The task of evaluating the various suggestions must, of necessity, be a continuing one. However, it has been deemed desirable at this time to publish a preliminary summary of the suggestions for the information of the members of the tax committees.

It would be impractical as well as confusing to attempt to include in detail every one of the suggestions received and this has not been done. A number of suggestions have been combined where they are either identical in nature or bear on the same general problem. On the other hand, the overlapping nature of many of the proposals has resulted in some unavoidable duplication in this digest. Some have been omitted as being of too specialized a nature to warrant general publication and a few may have been omitted by inadvertence due to the volume of the response. Moreover, because replies are still being received, a number could not be processed prior to publication of this report. However, the fact that a particular suggestion has been omitted should not be taken as any indication that it will not receive full consideration by the staff.

A number of suggestions have been received for improvement in the excess-profits tax and social-security taxes, but these have been omitted from the scope of the present report.

The staff expresses no opinion in this report on the merits of particular suggestions.

I. Income Tax

A. RATES AND SPLITTING OF INCOME

1. Individual income tax rates (secs. 11 and 12)

Under present law the starting rate on the first dollar of taxable individual income is 22.2 percent. This graduates up to 92 percent on incomes over $200,000 in the case of a single person, on incomes over $300,000 in the case of a head of household, and over $400,000 in the case of a married couple filing a joint return; such a graduation represents a range of 69.8 percentage points. The overall limitation at present is 88 percent.

A number of the replies to the questionnaire suggested a maximum tax rate of 25 percent. Others suggested that the rate should not exceed 40 percent and a number recommended a top rate of 50 percent. The argument advanced in support of these limitations has been that the present tax rates stifle initiative and free enterprise.

Taxpayers in general complained strongly about the steeply progressive individual tax rates and stated that there was no formula, scientific or otherwise, which was used as a guide in the successive legislative actions introducing the present excessive progression into the tax law. It was indicated that there is sentiment for narrowing the range of progression, as evidenced by the demand for a constitutional amendment to limit income taxes to a top rate of 25 percent.

One correspondent proposed that a substantial change in the rates of individual income tax and the progression therein be made by the following steps:

> First, reduce the bracket rates of the 1951 act (effective presently for the year 1953) by either of the two methods proposed below, whichever would produce the lower rate in each bracket:
>
> (1) Reduce the rates to those that become effective December 31, 1953; or
>
> (2) Reduce the progressive element of each bracket rate by 25 percent.
>
> The second of these methods may require some explanation. The tax rate applicable to the several taxable income brackets consists of two parts: These are the basic rate, which is actually the rate of the first taxable income bracket; and the true surtax or progressive element. For example, in the 1951 tax rate scale, the first bracket rate is 22.2 percent. This is the basic rate. The rate for the second bracket, applicable to taxable income $2,000–$4,000, is 24.6 percent, of which 22.2 percent is the basic element and 2.4 percent is the surtax or progressive element. At the third bracket the total rate is 29 percent, of which 6.8 percent is the progressive element. At the top of the scale the total rate is 92 percent, of which the surtax or progressive element is 69.8 percent. It should be noted that the rates that become effective December 31, 1953, involve a greater reduction, for the taxable income brackets up to $10,000, than would be attained by a 25 percent cut in the progressive elements of the rates to this point. Beyond the $10,000 level of taxable income, the 25 percent reduction of the progressive element of the rate produces a total lower rate. This method of reduction would narrow the range of progression from 69.8 percentage points to 54.5 percentage points, with a first bracket rate of 20 percent and a top bracket rate of 74.5 percent.

In addition, it was suggested that the next step should be to make another 25 percent reduction of the progressive elements of the rate scale effective for the year 1955, providing the budget prospects would permit the second reduction. This second reduction would narrow the range of progression from the 71 percentage points that would otherwise be effective for 1954 to 41 percentage points. The final suggested stage would be that which is contained in one resolution for a

constitutional amendment; namely, a restriction of the range of progression to 15 percentage points whenever it should be necessary to levy a maximum top rate in excess of 25 percent.

Furthermore, should the range of tax rate progression be narrowed or restricted, the stronger the case becomes, it is argued, for reducing the number of taxable income brackets. It is maintained that no sound case has ever been made for the present large number of taxable income brackets, 24 in all, of which 11 include no more than $2,000 of taxable income each, and it is argued that there can be no pretense of measuring with any accuracy by such a rate scale the variations of tax obligation in relation to income, assuming that some degree of progression is necessary for this measurement. It was suggested that the simplest step would be to reduce materially the number of taxable income brackets to no more than 3 or 4, or at most 6. Furthermore, it is argued that the problem of how or at what income levels the taxable income bracket divisions are to be set is as much a matter of guesswork when there are only 3 or 4 such divisions as when there are 24. However, it is stated that a small number of fairly broad income brackets would at least have the support of commonsense and ordinary experience, while there is no basis of support for the elaborate bracket system and erratic tax rate arrangement of existing law.

Another suggestion would impose a special flat-rate tax on all wages and salaries not in excess of $9,000 or $10,000. This flat rate of tax would be the withholding rate in such cases. Under the suggestion, withholding would continue to make an allowance for the standard deduction and exemptions in an amount proportionate to the particular pay period. For example, if the pay period were 1 month, withholding would make allowance for one-twelfth of the exemptions and standard deduction. This is the procedure today, but if at the end of the year the taxpayer's final liability is in excess of his withholding he is assessed a deficiency. This plan would eliminate such deficiency or refund as the case may be because the withholding in each pay period would be the liability. In addition, if it were found desirable to provide an earned-income credit, such a credit could be incorporated in the standard deduction. By adoption of this plan, it is contended, the Government and 30 to 40 million taxpayers would greatly benefit by elimination of final returns.

One taxpayer suggested that the individual rates should be decreased and that the revenue loss could be made up by an individual franchise tax of $60 to $100 a year on citizens aged 22 to 65.

It was suggested that since the large taxpayer is protected by the 88 percent ceiling, the small taxpayer should be protected by a taxable income ceiling such as a surtax exemption of $1,000 in the case of a single person and $2,000 in the case of a married couple. This would be in addition to the present personal exemptions.

It was suggested that in lieu of the present tax system there be imposed a gross income tax allowing personal exemptions and credits for dependents. Another suggestion would, in the interest of simplicity, impose a flat gross income tax with no deductions or exemptions, and still another correspondent recommended a graduated gross income tax.

The suggestion has been made that every individual be required to pay a minimum tax of $12 regardless of the number of exemptions or the amount of deductions. A further suggestion would be to combine the normal and surtax rates into one rate schedule with a tax credit for any partially tax-exempt interest. One reply suggested that as an incentive device a diminishing tax rate be provided which would apply to the income in excess of the average income for the preceding 5 years. In other words, if a taxpayer's average income for the preceding 5 years was $12,000 and in the tax year his income is $15,000, or $3,000 over his average, he would pay the regular tax rates on the first $12,000 but on the excess over $12,000 he would pay a lower rate than the top bracket rate applicable to his $12,000 income.

One taxpayer indicated that a tax credit over the working life of the taxpayer should be provided which would represent an allowance for physical depreciation.

It has been recommended that the 30-percent minimum tax and the 30-percent withholding tax as it relates to nonresident aliens be increased to 55 percent on the ground that while other tax rates have increased substantially there has been no such increase with respect to nonresident aliens.

2. Split income and head of household (*sec. 12*)

Since the Revenue Act of 1948, married couples are allowed to split their income in computing their tax liability; that is, to pay a tax which is twice the tax on half of their combined incomes. This, in most cases, results in a lower tax than if it were computed on the total. The Revenue Act of 1951 provided some relief for heads of household by giving them approximately one-half of the benefit received by married couples from full income splitting. However, the single individual who does not qualify as a head of household and who has the same income as a head of household or a married couple pays considerably more tax than do either of the latter, except in the case where such taxpayers are only subject to the first bracket rate.

In response to the questionnaire, suggestions have been received both for and against a separate rate schedule for married couples which would provide the same tax result as income splitting. The opponents of such a plan suggest that another rate schedule would complicate the tax form. However, others believe that it would be much simpler than requiring married people to go through the mechanics of dividing their income, computing the tax on half, and multiplying the result by two. The majority of the replies that considered this problem appear to favor a separate-rate schedule.

A number of individuals who now qualify as heads of household state that they are being discriminated against and maintain that they should receive the full benefit of split income and not just one-half. Some have suggested that any taxpayer with two or more dependents should have the same split income benefits as a husband and wife. Other single taxpayers who do not qualify as heads of household, but who maintain households, point out that they receive no benefit in any way whatever from income splitting and argue that the tax law should provide the same tax burden for all taxpayers on the same income after deductions and exemptions, as was the rule prior

to 1948 (except in community property States). To emphasize this, it was pointed out that a single person (not qualifying as a head of household) with one dependent and earning $25,000 a year pays about $2,800 a year more in tax than a married couple earning the same income. A more limited suggestion along these lines is the proposal that head-of-household treatment should be extended to such individuals who have dependents but eliminate the exemption for one of the dependents. Other letters point out that married couples and heads of households whose taxable income is in the first surtax bracket do not receive any benefit whatsoever from income splitting and suggest that some provision be made in order to extend to them a benefit comparable to that enjoyed by those with income above the first surtax bracket. It was suggested that this might be accomplished by allowing an extra personal exemption where the taxpayer receives no benefit from either the head-of-household or split-income provisions. Other suggestions have been made which would continue the advantage of full income splitting after the death of one spouse, either for a limited period of years or permanently. It is pointed out, in this connection, that a widower who continues to have the burden of supporting his children receives a substantial increase in tax burden under present law solely because of the death of his spouse and consequent loss of the split-income benefit.

3. Corporate income tax rates (*secs. 13 and 15*)

Under present law, the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, making a combined corporation income tax rate of 52 percent (exclusive of the excess profits tax). There is a $25,000 surtax exemption. The normal tax rate will revert, under present law, to 25 percent on April 1, 1954. Therefore, at that time the combined rate will become 47 percent.

As an aid to smaller corporations, various suggestions have been received for increases in the present $25,000 surtax exemption. The recommended increases range up to $100,000. In lieu of such a flat increase in the present exemption, some suggestions have been made for graduated exemptions on incomes up to $100,000. For example, one proposal would retain the present $25,000 surtax exemption, tax the next $25,000 at half the surtax rate, and the remainder at the full surtax rate. Another type of graduated exemption system would be achieved under a recommendation that, instead of a flat dollar exemption, the surtax exemption should be equal to 1 percent of gross sales.

With respect to the corporate tax rates themselves, as distinguished from the surtax exemption previously discussed, a fairly common suggestion would place a ceiling, such as 25 or 50 percent, on corporate taxes. Furthermore, some suggestions have been received for a graduated rate system, such as, for example:

	Percent		*Percent*
Up to $100,000	35	$300,000 to $500,000	45
$100,000 to $300,000	40	Over $500,000	50

A complete departure in principle from the present method of taxing corporate incomes is represented by a suggestion that, instead of a net income tax, there be a flat rate tax of 5 percent on gross profits.

Under present law, the primary difference between normal tax net income and surtax net income is that the former does not include partially tax exempt interest. It has been suggested that some method be adopted which would permit the use of a single rate schedule.

It was suggested that corporate earnings retained in the business should be taxed at double the rate of earnings paid out as dividends to stockholders.

(For recommendations relating to special exemptions and rates for new or expanding businesses and small corporations, see p. 16.)

B. GROSS INCOME (SEC. 22)

1. Convenience of employer rule

Under present Treasury regulations, income taxation of food, lodging, and similar items furnished employees depends upon whether these nonmonetary items are intended as compensation. Under prior Treasury regulations, the so-called convenience-of-the-employer rule exempted such items from gross income if they were furnished primarily for the convenience of the employer. The convenience-of-employer test has not been abandoned but is no longer necessarily controlling under present regulations. Thus, food or lodging may be furnished for the convenience of the employer but is taxable to the employee if other circumstances, such as the employment contract, indicate that it is intended to constitute part of his wages or compensation. Probably the basic complaint about the present tax treatment of such items is the uncertainty which surrounds the determination of taxability in the average case.

A return to the original rule has been suggested so that the value of food or accommodations furnished to the employee for the convenience of the employer would in no case be includible in the employee's taxable income. On the other hand, it is argued that the convenience-of-the-employer rule does not furnish an appropriate test of taxability, on the ground that board and lodging are no different than trainfare, carfare, or auto expense going to and from work and, therefore, are personal expenses.

It has also been suggested that, in applying the convenience-of-the-employer rule, the value of meals should always be included in the employee's income. However, the same suggestion recognized that the treatment of lodging should continue as at present on the ground that most employees who are furnished lodging by their employer have their own homes in addition and that the quarters furnished by the employer are usually for his convenience.

On the theory that income taxation should be based upon ability to pay, it has been suggested that all persons who receive additional compensation in the form of free room or quarters and/or free meals should have to report the same as income subject to taxation irrespective of whether or not such facilities are furnished in connection with employment. The only exception, it is stated, should be where the taxpayer maintains a separate home of his own and then has to stay in quarters "of not greater value than his own quarters" due to his work. Otherwise he would have to pay taxes with respect to two homes.

2. Life insurance proceeds and endowment contracts (secs. 22 (b) (1) and 22 (b) (2))

The proceeds of life insurance paid because of the death of the insured are generally exempt from income tax. However, the proceeds of a transferred life-insurance contract are exempt under present law only to the extent of the consideration and any subsequent premiums paid by the transferee. It is contended that the present rule discriminates against transferees and discourages the legitimate transfer of life-insurance policies, especially with respect to partnerships. It is suggested that all of the proceeds of a transferred insurance policy be exempt from tax. A more restricted proposal is the suggestion that the proceeds of a transferred insurance policy be exempt from tax if the transferee has an insurable interest in the life of the insured.

Another problem arising under the tax treatment of life-insurance proceeds concerns the uncertainty that is said to exist as to whether amounts received as death benefits under accident policies or under workmen's compensation laws are excludible from gross income. The exemption for life-insurance proceeds, as indicated above, deals with amounts received "under a *life* insurance contract, paid by reason of the death of the insured" (sec. 22 (b) (1), italics supplied). The exclusionary provisions of section 22 (b) (5), on the other hand, deal with amounts received "through accident or health insurance or under workmen's compensation acts, as compensation for personal *injuries* or *sickness*" (italics supplied. For a discussion of other suggestions relating to the provisions of sec. 22 (b) (5) see p. 10). The literal language of these two provisions might thus appear to be not applicable to amounts received as death benefits under accident policies or under workmen's compensation laws. It is contended that such amounts should be excludible from gross income and that the statute should be clarified to insure that result.

Under present law, if the proceeds of an endowment contract are paid in a lump sum to the insured, they are exempt to the extent that they represent a recovery of the cost of the policy. To the extent that the proceeds exceed the cost of the policy, they are taxable in full as ordinary income in the year received. It has been recommended that such a lump-sum payment be treated as a capital gain on the ground that it is unfair to tax as ordinary income in one year money that the recipient will have to depend on throughout his years of retirement.

(For discussion of the constructive receipt of income as it relates to the exercise of options under life insurance and annuity contracts, see p. 137.)

3. Employee death benefits (sec. 22 (b) (1) (B))

Employee death benefits not exceeding a total of $5,000 and paid under contract by an employer are excludible from gross income under present law. This exclusion was granted by the 1951 Act. It was intended in limited extent to grant such employee death benefit payments the same exclusion as is applicable to life insurance proceeds.

It is recommended that the $5,000 limit on exclusions should be removed. It is argued that the present statutory $5,000 limitation on death benefit payments treats inconsistently payments under a self-

insured employer plan and payments under a group life insurance plan. The cost of such plans in both instances is deductible by the employer, but the proceeds of the group life insurance plan are not subject to the $5,000 limitation.

The present statute provides no exclusion for death benefit payments by employers which are not paid pursuant to contract. The Treasury position prior to January 1, 1951, was that contractual arrangements resulted in the taxability of death benefits, on the ground that they were in the nature of additional compensation, whereas wholly voluntary payments were gifts and hence excludible. In I. T. 4027 (1950–2 C. B. 9 effective January 1, 1951) the Treasury partially reversed its stand and held that any payments by an employer to the widow of an employee in consideration of the previous services rendered by the employee, whether the payments were made under contract or not, constituted taxable income to the widow. Thus, under the present Treasury position, voluntary death benefit payments are taxable. As a result, it has been suggested that the benefits of the exclusion should be extended to voluntary payments by an employer to the widow or other beneficiary of a deceased employee.

4. Annuities and pensions in general (*sec. 22* (*b*) (*2*))

Under present law, pensions and annuities to which the recipient has not himself contributed are taxable in full in the year received. Where the recipient has borne part or all of the cost of such benefits, the amounts received are taxable under the so-called 3 percent annuity rule, which is designed to permit the taxpayer to recover tax-free that portion of the cost which he himself has borne. (For a discussion of the 3 percent annuity rule, see p. 9.)

Exceptions to the above general treatment exist in the case of social-security and railroad-retirement benefits. Both of these types of benefits are entirely exempt from income tax even though the recipient has paid only a portion of their total cost.

The existing favorable treatment accorded social-security and railroad-retirement benefits has given rise to much of the criticism directed to the present treatment of pensions and annuities. Many correspondents feel that the present exemption of these particular retirement benefits represents a discrimination against those individuals who must depend upon pensions received from other sources. While some correspondents suggest that this differentiation be corrected by removing the tax exemption of social-security and railroad-retirement benefits, most suggestions are along the line of extending either a complete or a partial exemption to other forms of pensions. Some of these suggestions take the form of an exemption from tax of all pensions up to some fixed dollar amount. One correspondent suggests an exemption for pensions and annuities of $10,000 annually. Another suggests a $3,000 exemption. A more detailed plan would provide a floor of $1,500 below which retirement income would be exempt from tax in the case of all taxpayers either (a) age 65 or over or (b) under 65 but retired with a pension or annuity from the former employer (either private employer or governmental unit) with further provision that the retirement exemption should be reduced to the extent of earned income in a manner similar to the Old Age and Survivor's Insurance reduction for the self-employed; however, the first

$900 of earned income would be permitted without reduction of the tax-free retirement income. This proposal would be applicable only to those taxpayers not now receiving exempt retirement income of $1,500 or more.

Another suggests that the amount of the exemption should be related to the cost of a "decent" standard of living for a retired individual or a couple. In general, a number indicate the belief that income from savings, as distinguished from income from work, is entitled to some sort of preferential treatment in view of the fact that the retired individual does not have the same ability to improve his income position as does the employed worker.

Other suggestions take the form of recommending the additional exemption of particular types of pensions. It has been suggested that the pensions of policemen, teachers, and firemen be exempt. Likewise, it has been suggested that civil-service pensions be exempt up to $1,400.

5. The 3-percent annuity rule (sec. 22 (b) (2))

Annuities and pensions to which the taxpayer himself has contributed are taxed under the so-called 3 percent annuity rule. Such annuity payments and contributory pensions are considered to be partly income and partly a return of capital. The present rule provides that at the time the annuitant first becomes eligible for annuity payments, a determination is to be made of the total amount which the annuitant himself has previously contributed toward the annuity. To the extent that the annuity payments represent the return to the individual of this amount which he himself has contributed, they represent amounts which have been previously taxable to him. This is because individuals receive no deduction for the purchase cost of an annuity or for contributions to a pension plan. The present law utilizes an arbitrary method of dividing annuity payments into the taxable-income portion and the portion representing nontaxable return of capital. Under the rule, pension and annuity payments received during a taxable year are taxable as ordinary income to the extent of 3 percent of the individual's total contribution, and the balance of each payment is tax-free until such time as the entire cost has been recovered. After that cost has been recovered through the tax-free portion under the 3-percent rule, the annuity payments are taxable in full. The 3-percent figure was adopted as a method of taking into account the income presumed to have been earned upon the individual's contributions, including interest earned.

One of the most common complaints concerning the operation of the present annuity rule is that many annuitants die before they have recovered their cost tax-free. As a result, it is frequently suggested that the proceeds from annuities should be entirely exempt until the entire cost of the annuity has been recovered. Subsequent to that recovery, the entire annuity payments would be subject to tax. Under this suggestion, for example, if an individual has paid $10,000 for an annuity of $50 a month, he would not be taxable on such annuity payments until they have aggregated his total cost of $10,000. Proponents of this suggestion point to the greater simplicity of the computations required.

As pointed out above, the portion of an annuity which is subject to tax is equal to 3 percent of the total cost of the annuity. For the

purpose of applying the 3 percent, the total original cost continues to be used each year irrespective of the fact that as annuities are paid out the reserve decreases and, accordingly, the interest on that reserve likewise decreases. The suggestion has been made, therefore, that the 3 percent be not applied to the total original cost but be applied to that cost less the amounts already distributed to the annuitant and received by him free of income tax.

It has also been suggested that the present 3 percent be reduced to 2½ percent, or even 2 percent, in order to more accurately represent present interest rates.

Another suggestion intended to avoid the arbitrary operation of the present rule is to utilize the actual life expectancy of the annuitant. Such suggestions take the form, for example, of excluding from taxable income each year that portion of the annuity which is equal to an amount computed by dividing the total cost of the annuity by the number of years of life expectancy of the annuitant. The excess over the amount so computed would be fully taxable. The proponents of this suggestion believe that it represents a more accurate method of permitting an annuitant to recover his cost tax free than does the present 3-percent rule.

It has also been suggested that where an annuitant dies without having recovered the cost of his annuity, the estate of the annuitant in its final return may take an income-tax deduction equal to the capital cost of the annuity not theretofore recovered tax-free. In such a case, if the deduction is in excess of the net income of the annuitant for the year, it has been further suggested that the difference may be carried back to the preceding taxable years of the annuitant which at the time of his death were not closed for income-tax purposes.

One correspondent has raised a question concerning the application of the present rule in a case where one individual has a number of annuities. The cost of one annuity may have been recovered tax-free and the full return from that annuity will thereafter be subject to tax, even though the annuitant may possess other annuities on his life the cost of which has not yet been recovered tax-free. Therefore, the suggestion was made that all annuities on one life be treated as a group for the purpose of applying the 3-percent rule.

6. *Employee disability benefits (sec. 22 (b) (5))*

Under section 22 (b) (5) amounts received as compensation for injuries or sickness, through accident and health insurance or under workmen's compensation acts, are excludible from gross income unless attributable to insurance in which case premiums previously allowed as medical deductions are not excluded.

Several States now have compulsory health insurance plans for employees generally. An employer may, however, adopt his own insurance plan provided it meets the standards set by the State.

It is not clear whether the self-insured plans of employers that meet the State requirements fall within the exclusion provisions of section 22 (b) (5). The present Treasury position appears to be that employees must include in gross income any sickness or disability benefits received under an employer's self-insured plan.

It is suggested that section 22 (b) (5) should be amended to make clear that it is applicable to receipts under any plan established by an employer to compensate his employees for personal injury or sickness.

7. Cancellation of indebtedness (sec. 22 (b) (9))

It is established by judicial decisions that a solvent debtor may realize taxable income from the cancellation of his indebtedness by his creditor.

Such income from the discharge of indebtedness may be excluded from gross income by corporate taxpayers under present law provided the indebtedness is evidenced by a security and provided further that the taxpayer files a consent to an equivalent reduction in the basis of his properties (generally properties which are security for such indebtedness).

It is stated that the present law is deficient in two respects:

(1) It does not apply to noncorporate taxpayers; and

(2) The requirement that the indebtedness be evidenced by a security is unnecessarily restrictive.

It is recommended that the requirement that the indebtedness be evidenced by a security be eliminated and that the cancellation of indebtedness section be extended to noncorporate taxpayers.

8. Improvements by lessee on lessor's property (sec. 22 (b) (11))

Under section 22 (b) (11) improvements by a lessee on the lessor's property do not constitute taxable income to the lessor upon the termination of the lease. A statutory exception to this rule exists when the improvements are intended as rent.

Where the parties intend the improvements to constitute rent, the Bureau of Internal Revenue has held that the lessor is taxable upon the annual value of improvements made (I. T. 4009).

It is contended that the Bureau's position makes taxable in a single year income which should properly be prorated over a period of years.

It is therefore suggested that section 22 (b) (11) should be amended to provide that improvements intended as rent should be taxable to the lessor over the remaining term of the lease.

9. Bad-debt recoveries (sec. 22 (b) (12))

Under section 22 (b) (12), recovery of a bad debt may be excluded from gross income if no tax benefit resulted when the bad debt was charged off. However, the Treasury regulations provide that section 22 (b) (12) does not apply to taxpayers using the reserve method for treating bad debts, on the theory that since the bad debt was charged against the reserve "it was not deducted."

It is urged that section 22 (b) (12) should be applicable to taxpayers on the reserve method. When charged against the reserve for bad debts, the bad debt written off affects the amount of the deductible addition to the reserve. Similarly, recoveries of debts previously charged to the reserve increase the amount of the reserve if they are credited to the reserve and thus may reduce the deductible annual addition to the reserve.

It has also been suggested that the tax-benefit rule on the recovery of bad debts and similar items should be extended to include transferees. A specific example given of an inequitable situation under the present law deals with the case of an estate that pays an assessment on bank stock held by it followed by a subsequent recovery of a portion of the assessment by a legatee. Although the courts have not limited the tax-benefit rule to the specific situations covered in section 22 (b) (12), they have not extended its application to transferees in situations similar to the above.

10. LIFO inventory method (sec. 22 (d))

In general, the Internal Revenue Code does not prescribe specific rules of accounting for inventories but authorizes rules to be prescribed by regulations that conform to the best accounting practice in the trade or business and that most clearly reflect income.

The regulations authorize several alternative methods of accounting for inventory. The two common bases of inventory valuation are (*a*) cost or (*b*) cost or market, whichever is lower. The taxpayer may elect either of these bases (or other specialized methods, such as the retail method or the unit-livestock-price method) but may not thereafter change except by obtaining permission of the Commissioner.

In valuing the inventory, identification of items with specific invoices is frequently impossible because of intermingling. In this situation the regulations provide that the items in the inventory will be deemed to be the items most recently purchased. This is commonly known as the FIFO (first in, first out) method of identification—the goods first purchased being deemed the first goods sold.

Section 22 (d), however, provides that the taxpayer may elect an alternative method of identification, popularly known as LIFO (last in, first out). The LIFO method treats the goods last purchased as being the first goods sold. Under the LIFO method goods are inventoried at cost. The taxpayer may use LIFO for all his inventory or for such class or classes thereof as he elects. The use of LIFO during a period of rising price levels tends to eliminate taxation of inventory profits since the inventory if not decreased in quantity will retain the original cost valuation applicable when LIFO was elected.

A number of taxpayers have proposed that the LIFO provisions in section 22 (d) should be amended to permit taxpayers using the LIFO method to value their inventories at the lower of cost or market. This proposal, it is indicated, would eliminate the taxation of inventory profits when the price level falls below LIFO cost. Others have recommended that the above proposal be adopted only for the period during which the excess-profits tax of 1950 is in force and for 5 years thereafter. This period, it is stated, would be of sufficient duration to eliminate any temporary aberrations in the price level due to emergency conditions. In support of this proposal it is contended that many taxpayers who desire to adopt the LIFO inventory method at this time and thus mitigate the effect of any inflationary trend during the emergency period are deterred from doing so because they would be compelled to value their inventories at present high-price levels even though prices may sharply decline in future years. If such taxpayers were permitted to adopt LIFO with the assurance that they could reduce the LIFO cost basis of their inventories to the lowest market price prevailing during the excess-profits-tax period and 5 years thereafter, they would be encouraged to take advantage of the have already adopted the LIFO method.

Special relief provisions are provided in section 22 (d) for taxpayers who, having elected the LIFO method, subsequently are involuntarily compelled to liquidate any part of their LIFO inventories. Such taxpayers may elect to replace the depleted LIFO inventory within a limited period. Upon replacement the taxpayer's net income for the

year of liquidation is adjusted for any increase or decrease in cost of the replacement in relation to the converted inventory. For involuntary liquidations occurring between 1941 and 1947, replacements must be made prior to January 1, 1953. For involuntary liquidations between 1950 and 1953, replacement must be made prior to January 1, 1956. Replacements are required to be attributed to the most recent liquidations not already replaced except that replacements made prior to 1953 are deemed to be replacements of 1941–47 liquidations prior to being treated as replacements of 1950—53 liquidations.

It is contended that present law does not provide an adequate period for replacement of LIFO inventories which were involuntarily converted during the period 1941–47. It has been proposed that the replacement period for these World War II period liquidations should be extended from January 1, 1953, to January 1, 1956. It is argued that this extension is necessary because the present emergency has made certain lines of goods nonavailable and thus prevented the replacement of World War II inventory liquidations.

Some correspondents have been concerned with the rule that any inventory replacements must be attributed first to the most recent liquidations (with the exception noted above for replacements made prior to 1953). Where substantial liquidations of LIFO inventories occurred during the years 1948 and 1949 any present replacements of inventory must be attributed first to those years instead of to involuntary liquidations occurring either during the World War II or present emergency period. It is contended that 1948 and 1949 liquidations should not be permitted to absorb replacements so long as liquidations occurring during the wartime or emergency periods remain unreplaced. Several proposals have been advanced in this connection. One would treat all liquidations occurring after 1947 as having occurred, for replacement purposes, immediately prior to the first taxable year during World War II for which the taxpayer made an election with respect to involuntary liquidations. In effect, this proposal would reverse the present general rule and would make replacements attributable to the most remote, instead of the most recent, liquidations. A somewhat different proposal but designed to accomplish the same purpose is the suggestion that replacements should be applied first to World War II involuntary liquidations, then to liquidations occurring during the emergency period, and then, following the general rule, to the most recent involuntary liquidations.

A belief has been expressed by some correspondents that the definition of involuntary liquidations is too narrow. Present law limits involuntary liquidations to those cases in which the taxpayer is unable to replace his LIFO inventory because of enemy capture or control of supplies, shipping or transportation shortages, material shortage resulting from priorities or allocations, labor shortages, and other prevailing wartime conditions beyond the taxpayer's control. It has been suggested that this definition should be expanded to include any liquidation for causes beyond the taxpayer's control, such as strikes, droughts, fires, or other casualties. Others have proposed that replacement of LIFO inventories should be permitted without regard to whether the liquidation was voluntary or involuntary in nature and without reference to any war conditions. This proposal would permit replacement within a limited period, say 5 years, and would not

require any reporting of income from the inventory liquidation until the expiration of the 5-year period. At the end of the 5-year period, the taxpayer would be required to report income resulting from the inventory liquidation to the extent the inventory was not replaced during the 5-year period, but no interest would be charged.

Another problem under the LIFO method relates to the use of the dollar-value method of inventory in conjunction with LIFO. This method was originally developed for large department stores which found it impracticable to physically match the goods on hand at the end of the year with the goods on hand at the beginning of the year. It has been suggested that the dollar-value method of LIFO inventory should be enlarged and clarified so that it could be adopted by manufacturers with varied inventories which include no single large item or items.

Several more general recommendations in regard to inventory methods include one suggestion that a taxpayer should be permitted to change from LIFO to FIFO at his option without the necessity of obtaining the consent of the Bureaus and another suggestion that the FIFO and LIFO methods should be eliminated entirely.

11. Alimony, separate maintenance, and support payments (secs. 22 (k), 23 (u), and 171)

As a general rule periodic amounts paid as alimony or for the separate maintenance of the wife are, under section 22 (k), taxable as income to the wife and deductible, under section 23 (u), by the husband.

However, in order to qualify for such treatment, the payments must be made pursuant to a decree of divorce or of separation. Where no decree is involved and the husband and wife merely enter into a written separation agreement, the treatment outlined above is not applicable and the husband cannot deduct the payments. This situation has been described as a hardship inasmuch as many couples have scruples against divorce or wish to avoid possible publicity involved in a court action. The suggestion has been made, therefore, that the husband be permitted a deduction and the wife be required to include payments in her taxable income where the payments are made pursuant to a written separation agreement.

Under present law, if a separation agreement is followed by a divorce but the requirement for periodic payments is not incorporated in the decree, no deduction is allowed even though the payments are continued pursuant to the original agreement. It has been recommended that, where there has been a decree of divorce or of separate maintenance and periodic payments are made in accordance with a prior separation agreement, the payments should be deductible by the husband and includible by the wife.

Under section 22 (k), where the periodic payments are attributable to property transferred in trust or otherwise, the amounts are excluded from the husband's gross income rather than being treated as deductions. Where the husband must deduct rather than exclude, he is denied the use of the optional standard deduction. Inability to exclude the payments from gross income also is disadvantageous with respect to the husband's medical deduction, although, conversely, it is advantageous with respect to his deduction of charitable contribu-

tions. It has been suggested, therefore, that all alimony or separate maintenance payments be treated as exclusions rather than as deductions.

Payments made for the support of children are neither excludible nor deductible by the husband, even though made pursuant to court order. It has been pointed out that where the children live with the divorced mother, the husband is not entitled to head-of-household treatment because in order to qualify for such treatment the children must live in the home of the parent claiming to be a head of household. Thus, the husband receives no deduction for the support payments and is denied head-of-household treatment even though he may bear substantially all of the expense of the children's support. This situation has been described as particularly inequitable because the wife who may bear practically none of such expense is entitled to head-of-household treatment merely because the children live in her home.

It has been suggested that payments for the support of minor children be deductible by the husband and taxable to the wife, although it has been pointed out by others that the wife might contend successfully that such payments do not constitute gross income to her.

One of the difficulties frequently referred to as arising under the present situation relates to the credit for dependents. While the husband cannot deduct his payments for the support of minor children, he is entitled under present law to dependency credits if he contributes more than half their support. However, the determination of which parent meets this test appears to be productive of considerable controversy, particularly where the situation between the divorced individuals is not amicable. As a partial solution, it has been suggested that a proportionate allocation of the credit be permitted. It has also been suggested that the allowance of a deduction for payments for the support of minor children would remove the difficulty. In such a case the wife would presumably include the payments in her income and would then be entitled to the full dependency credits. It has also been suggested that such a solution would remove the existing inequity of denying head-of-household treatment to the father.

12. Income taxes of lessor railroads

Where operating lessee railroads are required under terms of the lease to pay the income taxes of the lessor railroad company, the lessor company is deemed to derive additional income from the payment by the lessee of its taxes. Such additional income is also subject to tax which the lessee, in turn, must pay. The ultimate result is to carry the tax computation to practical infinity (less than 1-cent tax).

It is indicated that in loss years the deficit of the lessee may be increased by the lessor's taxes on its leased properties even though these properties, in reality, constitute a part of the entire business enterprise which is operating at a loss.

A suggested solution to the problem is to exclude such taxes from the lessor railroad's income and deny the lessee the right to deduct as rental any taxes it pays for the lessor railroad. This would be similar to present treatment under the excess profits tax.

13. Relief for new or expanding businesses and small corporations

(*a*) *In general*

To encourage small, new, or expanding businesses, special tax treatment has been recommended. Reduced rates, special deductions for capital expenditures exceeding current depreciation charges, and tax exemption for profits reinvested in plant and equipment have been suggested.

One specific proposal is advanced to alleviate the problem of obtaining adequate working capital: Wherever business increases by 10 percent above the volume done in the base year (1951), a percentage of the additional tax resulting should be eliminated by a relief credit, the percentage credit corresponding to the increase in sales volume over the base year. This relief would be limited to 25 percent of the additional tax, and be available only to businesses in existence 5 years or more, and be restricted to firms under a certain size as measured by sales volume or net income.

(*b*) *New businesses*

With respect to new businesses, most proposals fall into two general categories: Outright exemption or a special low rate.

Under one proposal, all new businesses would be tax-exempt for a period of 2 years. Another similar suggestion would limit such an exemption to new corporations of small size. It has also been pointed out that Canada grants a 3-year exemption to new mining ventures, and it has been recommended that similar treatment be granted under United States laws. A limited type of exemption would permit corporations for the first 5 years of their existence to enjoy tax exemption in an amount not exceeding the outstanding indebtedness with a provision that the accumulated tax-free profits be included in taxable income in later years.

Recommendations as to rates involve, in general, special lower rates in the early years of a corporation's existence. One such plan would apply one rate schedule during the first 5 years, a somewhat higher schedule for the next 5 years, and finally, the regular corporate rates after that period. Another proposal would involve either a tax at the regular rate on the following percentages of net income—

	Percent
1st year	20
2d year	35
3d year	50
4th year	65
5th year	80

or on the difference, net income minus additions to working capital, whichever provides the larger tax base.

Finally, with respect to new businesses, it was recommended that stockholders of new corporations be allowed a tax exemption on dividends received from such corporations, provided these dividends are not more than 50 percent of the individual's unearned income.

(*c*) *Small corporations*

Partnership option.—The general proposal that small corporations be given the option of being taxed as partnerships was approved by many respondents, but some opposed it. Of those in favor, some rec-

ommend that the option, once exercised, be binding; others that the option be available each year.

There were various suggestions for limiting the general proposal to corporations of the following types:

(1) Those having a limited number of stockholders (the proposed limit ranging from 1 to 25).

(2) Those having income not in excess of some fixed amount ($25,000, $50,000, or $100,000).

(3) Those whose capital is not in excess of some fixed amount (for example, $300,000 or $1,000,000).

(4) Corporations, all or at least 90 percent of the stock of which is held by members of one family and the gross income of which is less than $100,000 or $500,000 per year.

(5) Corporations all of whose stockholders work for the corporation and whose profit is less than $1,000 per employee.

(6) Corporations 50 percent of whose stock is owned directly or indirectly during the last half of the taxable year by not more than 5 individuals.

One suggestion in this general area would allow an annual election and require income for years in which the partnership method is used to be transferred to capital surplus, and income for years in which the business is taxed as a corporation to be transferred to earned surplus. Distributions from capital surplus would be considered under the suggestion as a return of capital and nontaxable, those from other accounts taxable as dividends.

(*d*) *Graduated tax for small, new, or expanding business*

Various proposals were made regarding special surtax exemptions for such businesses, such as $50,000 or $75,000. Furthermore, complete tax exemption for the first $1,000 or $25,000 of income was also suggested.

There have been a number of suggestions for the use of graduated rates with respect to the first $100,000 of income of such businesses. The rates suggested range from 5 to 50 percent in various income brackets. Such special treatment would be limited to a specified number of years, such as 5 or 10.

It was also recommended that corporations with gross business not in excess of $250,000 per year be allowed 5 percent of gross income as an exemption, present rates being applicable to any additional income.

(*e*) *Provision for reserves, reinvestment, etc.*

Among some of the more specialized suggestions with respect to small, new businesses are the following:

(1) Small corporations should be allowed a special tax exemption to enable them to build up reserves to meet losses, etc.

(2) Small corporations should be allowed a deduction for earnings which are reinvested, subject to some limitation.

(3) Tax-free accumulation of income not declared as dividends up to one-half of net worth should be allowed with a limit upon the amount of net worth which would be considered for this purpose.

It has also been recommended that expanding businesses be allowed to retain up to half of the income tax, not exceeding $10,000 per year for not over 3 years within a 5-year expansion period, for purposes

of expansion. In such a case, the tax liability would be subject to 6 percent interest per year, but no penalties for such deficiencies would apply and the Government would have a lien on all property until such tax deficiencies are paid in full. To prevent draining off of earnings under the proposal, there would be a limitation on dividends of such corporations and on amounts withdrawn in case of unincorporated businesses to which the proposal is applicable.

It has also been proposed that a flexible-payment schedule of corporation taxes be provided whereby payment could be made over an extended period by corporations investing additional funds in expansion of operations.

(*f*) *Financing—stocks, bonds, etc.*

Although not necessarily limited to small, new, or expanding businesses, the following suggestions have been made with respect to corporate financing:

(1) Allow as an expense all or part of the dividend cost of any new issue of preferred stock having a fixed dividend rate and subject to retirement within a given time.

(2) Allow corporations an exemption up to $250,000 on their preferred stock, in connection with which they could charge as an operating expense dividends paid up to 6 percent, provided one-tenth of the issue was retired each year through a sinking fund.

(3) For corporations which have no bonded indebtedness, provide for the deduction of a nominal rate of interest on actual investment in physical property.

(4) Allow a substantial credit to small business, based on average daily borrowed capital in the early years of operation.

(5) Allow a tax credit where it can be shown that debts were reduced, with a provision that the amount of indebtedness could not be incurred again for 90 or 120 days.

(*g*) *Expensing, depreciation, and deductions*

The following suggestions have been received in this area:

(1) Allow small corporations to treat as an expense item purchases of machinery up to $100,000.

(2) Allow small or medium-sized corporations to treat as expense items amounts spent for moderate repairs and changes in buildings.

(3) Allow a 20 percent annual rate of depreciation for all corporations whose net income is less than $25,000, with the limitation that the 20 percent rate must be consecutively applied for at least 5 years.

(4) Allow small corporations to treat research and development costs as current expense.

(5) For a corporation which has a deficiency of working capital, allow the deduction of accrued officer salaries even though payment is deferred, with the limitation that the accrued salaries must be paid within 5 years.

14. Treasury stock

Treasury Regulations (sec. 29.22 (a)–15) presently provide that the taxability of the acquisition and disposition by a corporation of the shares of its own capital stock depends upon whether the corporation deals in its own stock as it might in the shares of stock of another corporation. A correspondent has indicated that the present rule

leads to uncertainty and that the effect generally has been to impose capital gains tax when treasury stock is reissued at more than the price for which the corporation acquired it but to deny any deductible loss when the treasury stock is reissued for less than its purchase price. It has therefore been proposed that treasury stock should not be considered an asset and that its sale should not give rise to gain or loss.

15. Miscellaneous items of income

The following suggestions were received with respect to miscellaneous items of income:

(*a*) Interest on all future issues of State and municipal bonds should be subject to tax.

(*b*) Embezzled funds should be taxable to the embezzler and deductible in full to the taxpayer from whom embezzled.

(*c*) Compensation received by United Nations employees should not be tax-free.

(*d*) A gift by a farmer of crops to a charitable organization should not be deemed to result in taxable income to the farmer as has been held in a Bureau ruling.

(*e*) A life insurance salesman should not be held taxable on commissions earned from selling policies on his own life since doctors are not required to report as income medical treatment they administer to their own families nor are attorneys required to report as income the legal advice they give their own families.

(*f*) Newly married couples should receive a complete exemption from tax in the year of marriage.

(*g*) Cash and merchandise gifts to employees at Christmas time in an amount not to exceed $25 annually should be exempt from tax.

(*h*) Servicemen should be exempt from income tax.

C. ADJUSTED GROSS INCOME (SEC. 22 (n))

The concept of adjusted gross income was added to the code by the Revenue Act of 1944 in conjunction with the adoption of the simplified tax table and the optional standard deduction, both of which are based on adjusted gross income. This concept also determines the base upon which the limitations for charitable contributions and medical expenses are determined. In general, the deductions allowed by section 23 of the code which are subtracted from gross income to arrive at "adjusted gross income" are either (1) business expenses and losses or (2) losses from the sale or exchange of property. Provision is also made for deductions attributable to rents and royalties and for depreciation and depletion deductions allowed life tenants or income beneficiaries of trust property.

For purposes of using the tax table or the standard deduction, an employee may deduct in arriving at adjusted gross income expenses incurred in connection with his employment only if they are (1) reimbursed expenses or (2) expenses for travel, meals and lodging incurred while away from home. Therefore adjusted gross income is, in general, gross income less business expenses.

1. Traveling expenses (sec. 22 (n) (2))

As indicated above, present law allows an employee who travels and pays for his transportation, meals and lodging while "away from

home" on his employer's business to deduct such expenses in arriving at adjusted gross income and, in addition, he is allowed to take the standard deduction. The Bureau has ruled that a taxpayer is "away from home" only if he stays away overnight. This compares with an employee who incurs similar expenses but who does not stay away from home overnight and therefore under present rulings cannot deduct such expenses in arriving at adjusted gross income. As a result, he may deduct the transportation expenses (the expense for meals is not allowed to anyone who is not away from home overnight) only if he itemizes his deductions, thus losing the benefit of the standard deduction.

Numerous letters have been received on this subject and as a general rule they indicated that if the expense was incurred in earning income then it should be allowed as a deduction in arriving at adjusted gross income, whether or not the employee taxpayer was away from home overnight.

2. Business expenses

Employees frequently incur a number of other nonreimbursed business expenses which are not presently permitted as deductions in computing adjusted gross income though similar expenses are deductible by individual proprietors. Such expenses include entertainment of customers, commissions to other salesmen, union dues, cost of work clothes, and similar expenses for which the employee is not reimbursed. It is argued that deduction of such expenses should not preclude the employee from taking the optional standard deduction.

A specific illustration of the above is the case of postmasters in the smaller post offices who are apparently required to furnish operating items such as brooms, shovels for removal of ashes, cleaning soap powder, etc. They are not allowed to deduct these as business expenses in arriving at adjusted gross income because they are employees. It is suggested that they be allowed to deduct these expenses and still take the standard deduction.

3. Other expenses (sec. 22 (n) (4), (5), and (6))

Interest on loans to carry stocks is not an allowable deduction in computing adjusted gross income (unless attributable to a trade or business carried on by the taxpayer). On the other hand, interest on mortgages on real property held for the production of income is deductible. It has been contended that there is no logical reason for this differentiation and that all expenses attributable to property held for the production of income should be deductible in computing adjusted gross income. Similarly, it has been recommended that investment expenses, such as advisory service, should also be deductible from gross income in the computation of adjusted gross income. Under present law these expenses are allowed as deductions only where the taxpayer itemizes his deductions and does not elect the optional standard deduction. Some taxpayers have proposed that casualty losses and possibly alimony should be deductible in arriving at adjusted gross income.

D. DEDUCTIONS FROM GROSS INCOME (SEC. 23)

1. Trade and business expenses (sec. 23 (a) (1))

Present law provides that all ordinary and necessary expenses incurred in carrying on a trade or business, "including a reasonable allowance for salaries or other compensation for personal services actually rendered," are deductible.

It is urged that the requirement of reasonableness gives too broad a discretion to administrative authorities to deny deductibility of legitimate salary payments, and, therefore, it has been recommended that all bona fide salaries and wages that are not gifts or dividends should be deductible. Under this proposal, the specific requirement of reasonableness would be removed from the statute, and the deductibility of any given salary payment would be determined, as in the case with respect to other business expenses, simply on the basis of whether or not they are "ordinary and necessary." It has also been suggested that consideration be given to whether the employee should not be entitled to return to the corporation any portion of his compensation deemed excessive (and therefore nondeductible by the corporation), and recover the amount of income tax paid thereon, thus putting the parties in status quo without expensive litigation.

Under present law, the deduction of graft payments has been denied on the ground that such payments are contrary to public policy. It has been suggested that such expenses be permitted to qualify as business deductions to the extent that they are ordinary and necessary in the taxpayer's business.

Other expenditures whose deductibility is frequently denied under present law on the grounds of public policy are those incurred in certain legal settlements. In general, fines and penalties paid for violations of antitrust laws and similar regulatory laws have been held not deductible as ordinary and necessary business expenses on the ground that sharply defined public policy proscribes these acts. However, legal expenses incurred in connection with antitrust and similar litigation have been generally held deductible as business expenses.

Following the same rationale, amounts paid in settlement of antitrust suits are usually held nondeductible, but legal expenses incurred in reaching the settlement are deductible. It has been urged that these limitations of present law impose unnecessary restrictions on the deductibility of settlement payments. The proposal has therefore been made that settlement payments and related expenses in civil suits for violation of regulatory statutes should be expressly made deductible.

The suggestion has been made that much stricter requirements should be made for the deduction of expenses relating to yachts, farms, and recreation media. It has also been recommended that traveling and entertainment expenses should be substantiated with affidavits to be deductible and should be limited to 10 percent of gross income.

Under present law, charitable contributions by corporations cannot exceed 5 percent of the taxpayers' net income in order to qualify as deductions. If a payment would qualify as a deductible charitable contribution except for the 5 percent limitation, the expenditure cannot be deducted as a general business expense under section 23 (a). It has been suggested that the law be amended to provide that such

contributions may be charged as advertising and, thus, deducted as business expenses. In effect, such an amendment would remove the present 5-percent limitation.

2. Nonbusiness expenses (sec. 23 (a) (2))

A specific area of complaint in the deduction of nonbusiness expenses concerns brokerage commissions on the purchase of securities. Under present law the brokerage commissions are not deductible when the securities are purchased but only when the securities are sold. The theory upon which the commissions are disallowed as an expense when incurred is that they constitute capital expenditure, being part of the cost of acquiring title to the securities. It is contended that the present rule operates unfairly since only 50 percent of the commission expenses are taken into account if the securities are held for more than 6 months. Furthermore, it is said, the purchaser may never get a tax deduction for the brokerage expenses if he holds the securities permanently as an investment. On the other hand, the stockbroker must include the commissions in income. It is therefore proposed that brokerage commissions should be deductible as nonbusiness expenses when incurred.

3. Interest (sec. 23 (b))

Under present law, interest payments in general are deductible. However, interest payments not specifically segregated in installment purchases are not deductible, although a recent Bureau ruling has made some liberalization in this regard. The disallowance of such a deduction is apparently on the theory that what may resemble interest may, in fact, be simply inseparable from the purchase price. Thus, under existing rulings and decisions, the mere fact that property is purchased on time payments does not mean that any part of the consideration paid is interest where the purchase agreement itself makes no provision for interest. Installment purchases of automobiles are a common example of this rule, and interest deductions will be allowed only if the contract provides for the payment of a specific amount of interest. It has been suggested, therefore, that interest payments not specifically segregated in installment purchases be allowed as deductions. It has also been suggested that so-called "carrying charges" be permitted as interest deductions.

Under present law, interest charged to margin accounts with stock brokers and not settled in cash or offset by credits for dividends or interest received is not deductible unless the customer is on the accrual basis, in which case he may deduct interest as it is charged by the broker. However, if he is on the cash basis, any deduction must be based upon actual or constructive payment. A mere charging of interest to the account is considered to simply have the effect of increasing the customer's debit balance and does not support a deduction. It has been suggested that such interest charges be made deductible.

A taxpayer on the cash basis may deduct interest only if it is actually paid during the taxable year. As a result, the addition of interest to the principal of a life-insurance loan does not constitute payment, and it has been suggested that such an interest charge be permitted as a deduction.

4. Taxes (sec. 23 (c))

In general, all taxes paid or accrued during the taxable year are deductible. However, the statute specifically enumerates several exceptions, among the most important of which are Federal income and excise taxes (except to the extent to which such excises are deductible as business expenses).

In order to qualify for deduction as a tax, the particular tax in question must in fact have been paid by the taxpayer himself. For example, the Federal manufacturers' excise tax on a truck would not be deductible as a tax by the purchaser of the truck even though the amount of the tax was passed on to him by the manufacturer as a part of the purchase cost of the truck. If the truck is purchased for a business purpose, its cost must be recovered through depreciation deductions. Thus, in the example given, the expense of the "hidden" tax cannot be deducted as such in the year incurred but must be amortized along with the rest of the cost of the truck. As a result, it has been suggested that taxpayers be permitted to deduct so-called hidden taxes when the article so taxed is purchased.

As previously pointed out, Federal excises which do not constitute a business expense to the taxpayer are not deductible. It has been recommended that all such excises be deductible whether or not incurred as a business expense. This was in general the rule prior to 1944.

Ordinary State and local property taxes are deductible under present law. However, where a change of ownership takes place, a question of who is entitled to the deduction often arises. The courts have held that the parties to a real-estate transaction may not change the incidence of property taxes by agreement. It has been suggested that real-estate-tax payments made by one taxpayer for or on behalf of another should be allowed as a deduction to the payor and not considered as income to the other party. It has also been recommended that the taxes involved in real-estate transactions should be deductible by both the seller and the purchaser to the extent that the tax in question is in fact paid by each. This proposal arises because of the practice common in many localities of prorating the tax between the parties, even though it is technically a liability of the seller incurred before the sale, in cases where the sale of the property occurs within the tax period.

It has been argued that Federal income taxes paid for a prior year should be allowed as a tax deduction in the current year.

Federal stamp taxes on the issuance of stock or securities are not deductible as taxes under section 23 (c). Since 1944 their deductibility has been determined under the general provisions of section 23 (a), governing business and nonbusiness expenses. Thus, an issuing corporation is required to capitalize Federal stamp taxes on its stock and bonds. The stamp taxes on the bonds may be amortized over the life of the bonds but the stamp taxes on issuance of stock are deemed permanent capital expenditures. It is urged that the present treatment of Federal stamp taxes is unduly restrictive, and that the taxpayer should have an option to deduct currently or to capitalize and amortize Federal stamp taxes on the issuance of capital stock or bonds.

Several States now require employees to contribute to disability-benefit funds. The Bureau has ruled that employee contributions to

such funds are deductible as taxes if paid to the State fund but are not deductible if paid to State-approved plans of private employers. (See the discussion of employee disability benefits at p. 10.) It is urged that contributions to State-approved plans of private employers should be deductible by employees as taxes.

State bonus levies based on capital employed by a corporation within the State and subsequent increases in such capital are held to be capital expenditures and not deductible currently as taxes. It is argued that such levies are taxes although not so designated by the local State government, and that they therefore should be deductible as taxes for Federal income-tax purposes.

Under present law, local assessments against property owners for street and sidewalk improvements are not considered as taxes and are not deductible. It has been argued that such assessments benefit not only the taxpayer but also the general public. As a result, it has been suggested that they be deducted as taxes.

In many States liability insurance on automobiles is compulsory and, therefore, it has been suggested that premiums on such insurance should be allowed as a deduction.

5. *Casualty losses* (*sec. 23* (*e*) (*3*))

Under present law, losses from fire, storm, shipwreck, accident, war, or from theft are deductible for income-tax purposes if not reimbursed by insurance or otherwise.

In the case of nonbusiness property the amount of the deductible casualty loss is measured by the difference between the fair market value of the property before and after the casualty, except that the deduction may not exceed the adjusted basis of the property. The determination of fair market value is frequently a difficult problem. As a result, it has been suggested that the deductible casualty loss should include the cost of appraisal necessary to establish fair market value at the time of the loss.

It is also indicated that the right to deduct casualty losses should not depend upon whether the taxpayer is reimbursed by insurance if the taxpayer has not been allowed to deduct the insurance premiums. For example, it is proposed that a taxpayer be allowed a casualty loss on the destruction of his residence by fire even though his loss is partially or wholly reimbursed by insurance. As an alternative, it has been suggested that premiums on fire and windstorm insurance on the taxpayer's home and its contents should be allowable as deductions.

In general, in order to qualify as a deduction a casualty loss must be due to some sudden, unexpected, or unusual cause and must be sharply differentiated from depreciation due to ordinary wear and tear. Thus, while a deduction may be allowed for flood damage, a mere conjectural loss, based upon an estimated depreciation in land value, due to some natural element, such as the action of the sea during a storm, is not sufficient to support a deductible loss. Complaint has been received from several correspondents to the effect that the Bureau has been too strict in its interpretation of what constitutes an allowable loss in such cases, particularly where the damage is caused by unusually high winds and storm conditions. A related casualty-loss suggestion has been that landowners should be allowed as a deduction the expense of pro-

tecting waterfront property with a pier or retaining wall to minimize erosion. Complaints have also been received with respect to the present disallowance by the Bureau of losses resulting from the action of termites or from the destruction of trees by the Dutch elm disease.

Workman's compensation awards against individual householders are not allowed as casualty losses under the present law. An example of this is where a casual laborer may fall off a ladder and sustain serious injuries. The State compensation board may direct the householder-employer to give this laborer an award of several thousand dollars. In effect this award is a judgment against the employer and may be collected by levy upon the employer's property. It is recommended that such an award should be considered a casualty loss.

6. Loss on worthless subsidiary stock (sec. 23 (g) (4))

In general, loss on worthless stock of a subsidiary corporation may be taken as an ordinary-loss deduction rather than being subject to capital-loss limitations provided the taxpayer corporation (1) owns 95 percent of each class of the subsidiary's stock and (2) is a domestic corporation, and provided further that more than 90 percent of the subsidiary's gross income for all taxable years has been other than investment-type income.

It is contended that the requirement of 95-percent stock ownership seriously impedes the formation by two or more taxpayer corporations of subsidiary corporations to carry on research and development projects. Instead such projects must now be conducted as joint ventures. It is recommended that the 95 percent ownership requirement be reduced to 25 percent.

It is further stated that the requirement that 90 percent of the subsidiary's gross income be other than investment income is unduly restrictive. Where the subsidiary's operation of an ordinary commercial or industrial business has resulted in gross losses from sales an insignificant amount of investment income may disqualify it from affiliated corporation treatment. It is recommended that the phrase "gross receipts" be substituted for the phrase "gross income."

7. Gambling losses (sec. 23 (h))

The present law allows a deduction for gambling losses only to the extent of gambling gains.

A taxpayer has suggested that this rule be changed and that either gambling losses be deductible in full just as the gains, if any, are taxed in full, or that this provision be repealed.

8. Nonbusiness bad debts (sec. 23 (k))

Noncorporate taxpayers may deduct business bad debts in full but are subject to capital-loss limitations in the deduction of nonbusiness bad debts.

Under present Treasury regulations the character of the debt is determined by the relationship of the loss to the taxpayer's trade or business at the time of worthlessness rather than the relationship the debt bore at its creation or when acquired by the taxpayer. It is suggested that the determination of the character of bad debts should relate to the time the debt arose rather than to the time of worthlessness.

Also, under existing decisions, advances by shareholders to corporations are generally treated as nonbusiness bad debts when they become

worthless unless the taxpayer-shareholder is found to have engaged in the business of making such loans. It is suggested that debts which represent loans or advances to businesses in which the taxpayer has a financial interest as an employee, stockholder, or creditor, should be treated as business bad debts and should be deductible as such.

More sweeping proposals have been made by some correspondents who would eliminate entirely the distinction between business and nonbusiness bad debts. They argue that the capital loss limitations place arbitrary restrictions on the deduction of nonbusiness bad debts and that these debts should not be forced into the capital loss field. A related but more restricted proposal is the suggestion that where a debt is incurred in a transaction entered into for profit it should be fully deductible and should not be subject to the restrictions on deductibility of nonbusiness bad debts.

9. Depreciation and emergency amortization (sec. 23 (l) and sec. 124 A)

A reasonable allowance for exhaustion and wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business or held for the production of income is permitted as a deduction in computing net income. Thus, the statutory test is one of reasonableness.

The Treasury regulations provide that depreciation must be deducted in accordance with a reasonably consistent plan that will permit the aggregate deductions to equal the cost of the property (less salvage value) by the end of its useful life. The straight-line method or any other method in accordance with recognized trade practice is acceptable, but the burden of proof rests upon the taxpayer, who must maintain complete records of cost depreciation previously allowed, estimated remaining life, etc., in substantiation of the depreciation claimed.

A guide to determining useful life of property and depreciation rates is set forth in the Bureau of Internal Revenue's bulletin "F." This compilation sets out estimated useful lives for various types of assets in different industry classifications, including an allowance for normal as distinguished from abnormal obsolescence.

Many taxpayers have complained that the Bureau tends to substitute its judgment for that of the taxpayer in the determination of proper depreciation rates. To resolve this conflict it has been suggested that the code should authorize optional depreciation. This would mean that the taxpayer could write off all or any part of the cost (or other basis) of depreciable assets in the year of acquisition. The remaining cost would then be written off by the taxpayer in subsequent years in whatever consistent manner the taxpayer might designate. Some proposals would limit the optional depreciation method to assets acquired after a particular date, say December 31, 1952. Others would limit it to particular kinds of assets, such as durable productive equipment.

A variation of the optional depreciation proposal is the suggestion that the writeoff of newly acquired property should be permitted at any rate selected by the taxpayer, varying or uniform for each year, not to exceed 20 percent in any one year (unless the property has a useful life of less than 5 years). Other suggested maximum rates have been 25, 30, 40, and 50 percent.

Other taxpayers have proposed that the depreciation rate determined by the taxpayer should be binding upon the Commissioner provided the taxpayer follows a consistent accounting practice.

Another recommendation has been that the Commissioner should establish maximum and minimum rates of depreciation, and the taxpayer should then be permitted to select any rate within this range.

It has also been suggested that deductions which would result in a complete writeoff at the end of two-thirds of the estimated service life of the property should be authorized. A similar proposal for increasing the permissible depreciation allowance in the initial years is the suggestion that the taxpayer be permitted to select a depreciation rate that would enable him to write off two-thirds of the cost in the first one-half of the useful life of the property. A more technical recommendation which would accomplish substantially the same result is the following proposal: The declining balance method of depreciation with initial writeoffs not to exceed twice the permissible straight-line deduction should be authorized, together with an option to change to the straight-line method at any time until cost is recovered.

Some taxpayers have advocated that the 5-year amortization now allowed for defense facilities be allowed permanently, for all depreciable property.

Another source of taxpayer complaint is the burden of proof question. Prior to 1934 the Treasury regulations provided that depreciation deductions would not be disallowed unless shown by clear and convincing evidence to be unreasonable. Since 1934 the taxpayer has had the burden of substantiating the depreciation he claims with accurate and detailed records. It is stated that the present regulations give too large a measure of administrative discretion to Bureau agents and that the present rule has resulted in depreciation being used as a bargaining lever by revenue agents when other adjustments in the taxpayer's return are under consideration. Many taxpayers have recommended that the burden of proof should be placed upon the Commissioner by statute. Thus, the Bureau would have the burden of showing that the depreciation claimed by the taxpayer was clearly unreasonable. Others have suggested that the pre-1934 rule in the Treasury regulations should be reinstated, preferably by statute. Still others have suggested that the burden of proof of establishing the depreciation rate initially should be upon the taxpayer but that if any subsequent changes in the rate are proposed the burden of proof should be on the party proposing the change. Akin to this latter proposal is the suggestion that adjustments to the depreciation rate should be applicable only prospectively to the first return filed after the new rate is fixed. Adoption of such a proposal, it is said, would eliminate the vexatious problem of Bureau adjustment of the depreciation rate for all open tax years even though the rate claimed by the taxpayer had been accepted in prior audits.

The Bureau's bulletin F, which is supposed to be only a guide to the determination of useful life, has been the subject of much taxpayer criticism. It is stated that the Bureau's emphasis in bulletin F in the determination of the useful life of an asset is placed upon an engineering concept of physical life rather than upon an economic concept of efficient productive life. The bulletin F lives have also been criti-

cized as being outmoded and unrealistic. Some taxpayers advocate the elimination of bulletin F. Others would require the Bureau to revise the bulletin F lives to base them upon a concept of efficient productive life.

Another aspect of the depreciation problem is the difficulty of setting aside sufficient funds from the depreciation allowance to make replacement at the currently inflated price levels. As a solution to this question, some taxpayers have suggested that a separate deduction be given in addition to the depreciation allowance. This additional allowance would be based on the loss of purchasing power of the current depreciation dollar as compared to the purchasing power of the original cost dollar. Others have suggested that the taxpayer be permitted to set up a reserve for excess replacement cost on assets acquired prior to January 1, 1950. A related proposal would permit plants constucted prior to 1948 to be revalued at 1952 new replacement cost, with the difference between this value and depreciation previously allowed being deductible over the remaining useful life. Another taxpayer suggests that increased replacement costs could be met by an additional allowance based on a percentage of the depreciation deduction and adjusted each year in accordance with the Bureau of Labor Statistics price index. Still others would meet the replacement problem in part by permitting either optional depreciation or accelerated writeoffs in the methods described above.

Another area in which the present depreciation provisions are said to be inadequate is in the adjustment of basis of property to the extent of the depreciation either allowed or allowable. Under present law, it is claimed, the taxpayer frequently does not receive the full tax benefit of his depreciation allowance. It is true that the 82d Congress enacted legislation to overcome the effect of the Supreme Court's decision in the *Virginian Hotel* case, but this legislation afforded relief only where the taxpayer received no tax benefit from excessive depreciation *allowed*. It is suggested that similar relief should be extended where the taxapayer has received no tax benefit from the depreciation *allowable*. Also, the above legislation provided that the taxpayer had to elect to recompute the depreciation basis with respect to periods prior to January 1, 1952, and that such election had to be made prior to January 1, 1953. It is recommended that this election for pre–1952 periods should be extended for at least 1 year.

A special depreciation problem faced by many regulated industries is the necessity of computing depreciation and maintaining records in accordance with two or more different methods in order to satisfy the requirements not only of the Bureau of Internal Revenue but also those of the regulatory bodies, such as the Interstate Commerce Commission, the Federal Power Commission, the Federal Communications Commission, the Securities and Exchange Commission, the Civil Aeronautics Commission, and others. The problem is frequently compounded where the business is also subject to the requirements of State regulatory agencies. It is indicated that the administrative problems of such industries would be greatly simplified if all the regulatory agencies could agree on the proper method of computing depreciation. The problem of the railroad industry in this connection has led to the proposal that the basis of any railroad property should be cost where cost can be readily ascertained from existing records, but if cost cannot

be so determined, the basis should be the cost of reproduction new of the unit as determined by the Interstate Commerce Commission (using 1910–14 prices), suitably adjusted to include overhead costs applicable to the unit, including both taxes and interest during construction.

Several letters have been received advocating special depreciation provisions for small businesses. One suggests the following specific provisions: (1) any taxpayer be allowed at his option to charge to expenses in a year the first $20,000 of depreciable capital expenditures made within that year, (2) that any taxpayer be allowed at his option to use a 5-year depreciation period for the next $80,000 of depreciable capital expenditures made within a year, and (3) any depreciable expenditure over $100,000 made within a year to be depreciated at normal rates. Another proposes generally that small businesses be permitted accelerated depreciation for limited amounts.

The question of depreciation of leasehold improvements by lessees has been suggested as an area of needed legislative clarification with study of whether it would be most desirable to permit depreciation either (1) over the life of the improvement or (2) over the life of the lease or (3) over the life of the lease plus any additional renewal period.

One taxpayer writes that the most necessary change in depreciation policy is a basic change in the underlying concept of depreciation. He suggests that instead of looking at the asset from the viewpoint of obsolescence, the approach should be one of supercession. By supercession is meant the time at which new and better equipment becomes available.

Another taxpayer expresses the belief that the present depreciation practices are so deep rooted and cause so much difficulty, the only solution would be to base the depreciation allowance on a percentage of gross profits, similar to the present provisions for percentage depletion.

To avoid depreciation disputes over relatively small items one letter suggests a statutory provision for expensing currently any capital expenditures of less than $50. Another would provide by statute that capital expenditures of less than $100 could be written off over a maximum period of 5 years regardless of the useful life of the property. Another has suggested that during the emergency period taxpayers should be permitted to amortize all building repairs and remodeling over a period of 5 to 10 years instead of over the useful life of the property.

One letter suggests that Congress might find it wise in the period of defense mobilization to deny or drastically limit the depreciation dededuction in the case of buildings or plant additions which compete for building materials and machinery but add nothing to necessary productive facilities. Canada has adopted such a scheme for the emergency period. On the other hand, greater than normal depreciation rates should be allowed in a time of depressed business activity.

Another writer expresses the belief that capital-gains treatment on the sale of depreciable assets is unjustified and that any gain on disposition should be treated as ordinary income.

A somewhat limited depreciation problem but one of fairly widespread interest is the question of depreciation of facilities to reduce stream pollution. Under existing law, facilities which are installed

for the abatement of water pollution may be depreciated over the useful lives of the depreciable components of such facilities. It is urged that these facilities, usually being required by local or State law, do not contribute to the production of income and therefore the total cost of such facilities, including land, should be amortized over any period selected by the taxpayer. A similar proposal has been advanced in regard to facilities installed to abate air pollution.

Another correspondent points out that off-street parking facilities have become of growing importance in crowded urban areas. Such facilities are frequently provided in connection with another trade or business of the taxpayer, such as the operation of an office building or department store. It is argued that such facilities should be permitted an accelerated form of depreciation, particularly in view of the fact that they contribute more to the welfare of the community as a whole than to the profits of the particular taxpayer.

Another limited aspect of the depreciation problem is the question of amortization of purchased goodwill and covenants not to compete. When a going business is acquired, the taxpayer must frequently pay a sum in addition to the value of the net assets, such sum being attributable to the established goodwill of the business or, in certain instances, attributable to an agreement by the former proprietor not to compete with the purchaser. Under present law the amounts so paid are deemed capital expenditures, not subject to depreciation. It is urged that such purchased goodwill and covenants not to compete have only a limited life and should therefore be amortized by the purchaser over some arbitrary period, say, 10 years.

The suggestion was made that one-unit enterprises, such as a refinery, dependent upon depleting natural resources in the immediate locality, be provided special tax treatment because when the resources in the area are depleted such enterprises become useless. It was recommended that these plants be allowed to recover their cost before the application of any tax, with the limitation that this treatment should apply only in cases where raw materials cannot be brought to the plant from outside the area where it is located.

EMERGENCY AMORTIZATION (SEC. 124 A)

In lieu of the deduction for depreciation under section 23 (l), the taxpayer may elect to amortize over a 60-month period facilities certified as emergency facilities by the Director of Defense Mobilization. The amount of the amortization deduction is determined by the amount of the adjusted basis of the property which the certifying authority designates as necessary in the national defense. Only facilities constructed or acquired after December 31, 1949, are eligible for certification and application therefor must be made within 6 months after acquisition or beginning of work on a facility.

It is stated that the present amortization provisions are defective in the following respects:

(1) No provision is made for a shortened amortization period in the event the emergency period is terminated or the need for the emergency facility no longer exists.

(2) There is no provision for a shortened amortization period for industries that fulfill emergency production needs early in the emergency period.

(3) Certification of only a percentage of the cost of an emergency facility based on postemergency utility fails to give sufficient weight to the need for the facility in the emergency period.

It has been sugested that the present amortization provisions should be amended to provide as follows:

(1) Amortization may be taken over the actual period of the emergency or 60 months, whichever is shorter. The emergency period should be deemed terminated on a date declared by Presidential proclamation or when the need for the emergency facility is stated to no longer exist.

(2) The emergency period should be deemed terminated for a particular industry if such industry is determined to have fulfilled emergency production needs.

(3) Percentage certification should be based only upon the need of the facility for national defense and should not be based upon any concept of postemergency utility.

10. Depletion (sec. 23 (m) and 114)

In general, mineral and other natural deposits are subject to a reasonable allowance for depletion under present law. The basis for determining the allowance for depletion is cost (or other sec. 113 basis). Recovery of cost is achieved by computing the per-unit cost of the estimated available resources, applying that unit cost to the number of units annually extracted to arrive at the depletion allowance. For certain extractive assets an alternative method of computing depletion is allowable as percentage depletion. Percentage depletion permits a depletion deduction based on a percentage of gross income from the property not to exceed 50 percent of net income from the property. Where percentage depletion is allowed, the greater of cost or percentage depletion is required to be taken as a deduction. (See appendix B for data as to rates of percentage depletion under present law and their dates of enactment.)

Some taxpayers have advocated that the depletion provisions should contain a definition of what constitutes a "mineral property" for purposes of determining the depletion allowance. They recommend that the definition of "mineral property" should include any separate mineral interest or, at the option of the taxpayer, a combination of separate mineral interests constituting an operating unit whether or not such mineral interests are included in noncontiguous parcels or tracts.

Others have suggested that clarification is needed of the phrase "net income from the property" in the percentage-depletion provisions of section 114. In general, they would define "net income from the property" as gross income derived from the extraction of minerals from the property minus allowable deductions directly attributable to such property but excluding from deductions all financial overhead expenses such as interest, taxes, etc. Other general overhead expenses, according to the proposed definition, would be allocated to all properties whether productive or nonproductive.

The special problem of extending the percentage-depletion provisions to ore recovered from tailings and dumps is of concern to some taxpayers. They argue that this ore would be subject to percentage depletion if it were economically feasible to separate it at the time of

extraction; therefore percentage depletion should not be denied because the separation process is postponed until the time it becomes a profitable operation.

Some have suggested that the percentage-depletion provisions should be applicable to all mines and quarries and that the depletion allowance for various minerals and for coal should be increased. Others have suggested that the percentage-depletion allowance should be made available to shareholders of mining corporations. They would permit the shareholders to exclude dividend distributions from gross income in the same ratio that depletion is allowed against the income of the corporation.

The Revenue Act of 1951 extended percentage depletion at a 5-percent rate to brick and tile clay. It is understood that, in determining the gross income from the property to which percentage depletion will be applicable in this case, the Bureau of Internal Revenue contemplates only taking into account the value of the raw clay itself. It has been argued that this proposed interpretation of the law will result in such an insignificant depletion allowance as to nullify the intention of Congress. It has been suggested that the proper basis for depletion in this case is the value of the finished brick or tile on the ground that this represents the first "commercial marketable mineral product."

It is argued that the present 5-percent depletion allowance for sand and gravel does not represent enough of a return to place the damaged land in a useful condition again, and that the 5-percent allowance should therefore be increased to 10 percent.

Similarly, it has been stated that slate must compete with many other mineral products that enjoy a 15-percent depletion allowance, and therefore the percentage depletion allowance for slate should be increased to 15 percent. Gypsum is also said to be as important to the national economy and defense effort as many minerals in the 15-percent allowance category and should thus have a percentage depletion allowance of 15 percent.

One taxpayer writes that the percentage depletion allowance for phosphate ores should include the operation of furnacing since the furnacing process of such ores yields the first commercially marketable product—elemental phosphorus.

A number of letters have expressed the belief that percentage depletion gives an unwarranted tax advantage to those fortunate enough to have income from the production of oil, gas, coal, and other minerals. It is argued that this tax favor is extended at the expense of other taxpayers. Some advocate restricting percentage depletion to recovery of all capital costs. They would soften this restriction by permitting percentage depletion against any capital costs of the taxpayer and not simply those of the producing property. They would also permit depletion of mineral-development costs and similar capital expenditures which produced no current tax benefit to be carried forward or backward for 5 years. This proposal, it is said, would permit mineral operators to recover their total capital expenditures and would encourage exploration but at the same time would remove the subsidy features of percentage depletion. Others have suggested limiting the total depletion allowance to twice the capital expenditures on the facility to which the depletion relates.

The percentage depletion allowance of the petroleum industry has been singled out for special criticism. One correspondent indicated that because of the current high tax rates, the petroleum industry appears to have a relative advantage not contemplated when the original 27½ percent allowance was first enacted. Others state that the percentage depletion allowed landowners on whose property oil is discovered is a bonanza, especially after the initial years when the inconvenience of the well has been compensated for. It is also stated that the Government never recovers any tax due in instances where the landowner takes percentage depletion on advance oil royalties but the well is never drilled or proves dry.

On the other hand, it is urged that any attempt to reduce the percentage depletion allowance on oil would prove to be a serious mistake since the allowance is deemed necessary to encourage geological search and development.

Another taxpayer suggests that where percentage depletion is not applicable, the taxpayer's determination of available deposits should be accepted, with the burden of proof on the Bureau to show that the rates or amounts so determined are excessive.

11. Charitable and other contributions (secs. 23 (o), 23 (q), and 120)

Under present law, charitable contributions of individuals are deductible to the extent of 20 percent of the taxpayer's adjusted gross income. Corporations are limited to 5 percent of their net income.

In order to qualify as a charitable contribution, the gift must be made to certain types of donees specified by law and such a donee must be an organization. Thus, a gift to an individual would not be deductible under present law. It has been pointed out that many taxpayers assist in the support of needy relatives or friends or other persons but are not entitled to treat such payments as deductible contributions, and it has been suggested that deductions be permitted in this area.

Where taxpayers have sought to deduct the value of blood donated to the Red Cross, the deduction has been denied, apparently on the ground that such a donation is in the nature of the rendering of a service rather than a deductible charitable contribution. Inasmuch as a pint of blood today has a readily ascertainable market value, the suggestion has been received that such donations be treated as charitable contributions.

Another reported difficulty involves gifts in kind to charities. Under present law where a contribution or gift is made in property, other than cash, a deduction is allowed to the extent of the fair market value of the property at the time of the gift. However, it is stated that the Bureau will not allow a deduction for the expense, if any, of installing the gift, and it is suggested that this distinction is unenforceable, representing a loophole because the taxpayer can avoid the rule by simply attributing to the cost of the property an amount equal to the installation charges.

One suggestion has been received to the effect that where a taxpayer pays all or part of the cost of educating one or more individuals a portion of tuition and other education expenses be deductible as a charitable contribution to the educational institution concerned. (For a general discussion of educational expenses, see p. 46.)

The allowable amount of charitable deductions was raised in 1952 from 15 to 20 percent of the taxpayer's adjusted gross income. However, a number of suggestions have been made that this limitation be removed in its entirety because of the importance of encouraging charitable contributions. Some have indicated the belief that the standard deduction has operated to reduce the amount of contributions made and should, therefore, be repealed. One correspondent suggested that contributions should be allowed as a deduction from gross income in arriving at adjusted gross income so that the taxpayer could still take the standard deduction.

As pointed out above, charitable contributions by corporations cannot exceed 5 percent of the taxpayers' net income in order to qualify as deductions. If a payment would qualify as a deductible charitable contribution except for the 5 percent limitation, the expenditure cannot be deducted as a general business expense under section 23 (a). It has been suggested that the law be amended to provide that such contributions may be charged as advertising and, thus, deducted as business expenses. In effect, such an amendment would remove the present 5 percent limitation.

One corporation has indicated that the present 5 percent limitation based on net income forces companies to be conservative in determining the amount of their contributions. This is because it is frequently important for the taxpayer to accurately compute its true net income before the close of the year. As a result, many corporations feel compelled to restrict their contributions in order to be sure that they will fall within the allowable limit of deductibility. Of course, a recent amendment to the law permits an accrual basis corporation to elect, at the time of filing its return, to deduct the contribution in the year authorized by the board of directors if payment is made within 2½ months after the end of the year.

A number of suggestions relate to some liberalization of the present 5 percent limitation with respect to corporations. One correspondent suggests the allowance of deductions up to 10 percent of net income with a ceiling of some fixed dollar amount. Another suggestion would permit corporations the same 20 percent deduction as is available to individuals, and still another has recommended that the limitation be either two-tenths of 1 percent of sales or the present 5 percent of net income, whichever is higher. Elimination of the percentage limitation altogether has been proposed in the case of corporations that have more than 10 stockholders and in which no single stockholder owns more than 10 percent of the stock.

Under section 120, an individual taxpayer is allowed an unlimited deduction for contributions if in the taxable year and in each of the 10 preceding taxable years the amount of the contributions plus the amount of income taxes paid exceeds 90 percent of the taxpayer's net income (computed without regard to any deduction for contributions or gifts) for each of those years. It has been suggested that this provision be liberalized by providing that if the taxpayer meets the 90-percent test, failure to meet the test in 1 or more succeeding years, not exceeding 3 separate years none of which are consecutive, should not bar the taxpayer from the benefits of the section in the current year. Moreover, it has been suggested that the law should be graduated so that the limitation moves from 20 to 100 percent in gradual steps.

For example, a taxpayer who met the 90-percent requirement for 5 consecutive taxable years should have a 50-percent limitation, for 8 consecutive years a 80-percent limitation, etc.

12. Deferred compensation (employees' annuities, pension, and profit-sharing plans) (secs. 23 (p), 165, and 22 (b))

In general, payments by an employer to a pension trust or profit-sharing plan are deductible if the plan qualifies under section 165 of the code.

In order for payments to pension trusts or annuity plans to be deductible, their total must not exceed 5 percent of the aggregate compensation of all covered employees. (An additional allowance is also made for the funding of past service costs.) On the ground that this is an unnecessarily stringent limitation, it has been suggested that deductions be allowed up to 10 percent of payroll. An integral part of this suggestion is the further recommendation that any unused portion of such a limit should be allowed as a carryover to future years as is allowed with respect to the profit-sharing-plan limitation.

Payments to profit-sharing and stock-bonus trusts are deductible under section 23 (p) if they do not exceed 15 percent of the compensation of all covered employees. Various suggestions have been received to the effect that this limitation should be entirely removed. It is pointed out that company earnings vary considerably from year to year and that a fuller participation in the good years would help to tide over the poor. Furthermore, it is argued that a primary purpose of a profit-sharing plan is to provide an extra personal incentive for each employee to maximize company earnings. Under present limitations, it is stated that this incentive is reduced or removed once company earnings reach a given level.

Under present law, payments to exempt trusts or profit-sharing plans are deductible only in the year made (except for certain carryover provisions) except that an employer on the accrual basis may deduct payments made within 60 days after the close of the taxable year. It is stated that this period is insufficient in view of the difficult actuarial computations involved and because it is frequently difficult to determine accurately the company's profit for the period in question. It was also stated that the 60-day provision bears no relation to any taxable event and is apt to be overlooked. As a result, it has been suggested that section 23 (p) (1) (E) of the code be amended to provide that payments to a pension or profit-sharing trust by an accrual-basis taxpayer shall be deductible if made prior to the due date for filing the return, including any extensions thereto.

To qualify as an exempt trust under section 165, the trust must be part of a pension, profit-sharing, or stock-bonus plan for the exclusive benefit of employees or their beneficiaries. The plan cannot discriminate in favor of employees who are stockholders, officers, or supervisory personnel. There has been a suggestion that this prohibition against discrimination should be liberalized on the ground that it prevents appropriate recognition of the managerial group. It is argued that present tax rates make it increasingly difficult to adequately compensate this group and that such rates impair or destroy the incentive value of increased current compensation. An exactly contrary suggestion has also been received to the effect that deduction

should not be allowed with respect to any part of an employer contributions to a pension fund which represent premiums for benefits in excess of $10,000 per year for any one individual.

If the trust is exempt as part of an approved plan, the employer's contributions to the plan are not taxed to the employee until he receives distributions therefrom. If the plan is a contributory one, the distributions are taxed as an annuity. If the plan is noncontributory the distributions are taxed in full to the employee upon receipt. However, where total distribution is received in a single year on account of the employee's separation from service, capital-gains treatment is provided. Where such distribution includes securities of the employer, taxation of gain on appreciation is deferred until the employee disposes of the securities. Although section 165 (b) prescribes capital-gain treatment for lump-sum distribution from a qualified trust upon separation from service, there is no similar provision in the case of distribution from a qualified plan where no trust is involved, or where the lump-sum distribution is made after retirement of the employee. It is argued that taxing such lump-sum payments as ordinary income in the year received, even though the income has been accumulated over a period of years, is inequitable. It is pointed out that where the lump-sum payment is paid to the employee's widow or beneficiary, the dissipation of the benefit payment through disproportionate taxation results in a dimunition of the security of the employee's dependents, thus defeating an important purpose of the plan. It is suggested, therefore, that capital-gain treatment should be extended to lump-sum payments by qualified nontrusteed plans and to such payments after retirement of the employee. It has also been contended that the requirement that total distributions be received in a single taxable year if the distributee is to qualify for capital gains treatment has proved too inflexible. It has therefore been suggested that the requirement be changed to an alternative one of distribution within a single taxable year or of total distributions within 1 year after the employee's death.

It appears that, under present law, where an employer purchases a single premium annuity, establishes an irrevocable trust or by some other means sets aside a lump sum for a present or former employee not covered by a section 165 pension plan, the employee is taxed on the total cost of the annuity as income in the year it is irrevocably set aside for him even though the amount is to be paid in annual installments. It has been suggested, therefore, that in such cases the employee should be taxed only on the amount received each year rather than on the lump sum at the time it is irrevocably set aside by the employer.

The capital-gains treatment under section 165 (b) described previously, which is applicable when an employee receives total distributions in one taxable year on account of separation from service, has been held inapplicable in a case where the distribution was made because of the liquidation of the employer and the termination of the plan. The Bureau has taken the position that the distribution was not made because of separation of the employee (which the law specifically covers) but because of termination of the plan (which the law does not cover). As a result, it has been proposed that section 165 (b) should be amended to provide that an employee shall be

entitled to capital-gain treatment on total distributions made because of severance of employment, liquidation of the employer, or termination of the plan.

Prior to the Revenue Act of 1951, appreciation in value during the period securities of the employer or other securities were held by qualified trusts was taxed at the time of distribution regardless of the source of the funds used to purchase the securities. The Revenue Act of 1951 provided an exception for distributions of securities of the employer in instances where the total distributions payable with respect to an employee are made within one taxable year as the result of the employee's separation from the employer's service. In such cases the appreciation is now excluded in determining the distributive value of securities of the employer purchased with employee and/or employer contributions. Public Law 589 further extended the exception to any distribution of employer securities purchased with employee contributions only, even though the distribution was not the result of the employee's separation from service. Section 165 (b), as amended, defines the terms "securities of the employer corporation" as including securities of a parent or subsidiary corporation. However, the present subsidiary relationship is limited to situations in which a parent company or subsidiary has more than 50-percent stock ownership in the employer corporation. It has been pointed out that there are many cases in which the stock of the employer corporation is held by two or more parent corporations and is not available for purchase by employee trusts. In many of such situations, no one of these corporations owns more than 50 percent of the stock of the employer. As a result, employees of such corporations cannot exclude the unrealized appreciation in computing gain or loss upon receipt of distributions from employee trusts even though the distributions consist of securities of the parent companies. It has been recommended therefore, that, when a majority of the voting securities of the employer corporation are held by corporate shareholders, the term "securities of the employer corporation" should include securities of the parent companies without restriction with respect to the percentage ownership of the combined voting power of all classes of stock.

In addition to deductions of payments to qualified trusts or plans, section 23 (p) also allows the deduction of payments under any plan of deferred compensation if the employee's rights to such payments are nonforfeitable. However, where the employer contributes to a nonexempt pension trust or other plan in which the employees' rights are forfeitable, the employer may not deduct its contributions. As a result, it has been suggested that section 23 (p) (1) (D) be amended to provide that such contributions be deductible in the year that the trust makes payment to the employee even though the employee's rights were forfeitable in the year the contributions to the trust were made. In the alternative, it has been suggested that the employer's contributions should be deductible in the year the employee's rights become nonforfeitable.

It has been stated that present law makes insufficient provision for pension plans that are contributed to by more than one corporation, including such problems as the liability for pensions of employees shifted between affiliated corporations. As a result it has been suggested that section 23 (p) be amended to provide that where a pension

plan or trust covers more than one corporation, the taxpayer shall have the option to treat the plan for purposes of the limitations contained in section 23 (p) and section 165 either as the plan of a single employer or on a separate corporation basis.

With respect to so-called union-welfare funds, it is understood that the Bureau of Internal Revenue has taken the position that contributions by employers to funds which provide such benefits are not deductible for income-tax purposes unless the funds meet the requirements of section 23 (p), relating to conventional pension or annuity plans. The funds in question are set up under section 302 (c) (5) of the Labor Management Relations Act, which permits payments to trusts set up by unions for the sole benefit of employees and their families. No other standards are prescribed. As a result, it is difficult in most cases, if not impossible, to meet the requirements of actuarial soundness applicable to deductions under section 23 (p). It has been proposed, therefore, to correct this situation by providing that the deductibility of contributions to union-welfare trusts should not be determined under section 23 (p) but under section 23 (a) relating to ordinary and necessary business expenses.

Section 22 (b) (2) (B) of the code, relating to the treatment of employee annuities, includes the phrase "or if an annuity contract is purchased for an employee by an employer exempt under section 101 (6)," the effect of which is that such an annuity contract receives the same treatment as an annuity contract issued under a plan qualified under section 23 (p), both as to the deductibility of contributions by the employer and as to taxation of the proceeds. It is stated that the purpose of the provision was to give equivalent treatment to annuity plans of employers exempt under section 101 (6) without imposing on such plans the same restrictions deemed appropriate for ordinary commercial employers. It is suggested, therefore, that, if new tax consequences are provided with respect to qualified annuity plans, the same equality of treatment should be maintained. Reference is made, for example, to proposed amendments which would extend to annuity plans the capital-gain treatment for lump-sum payments by reason of death or separation of the employee, which presently obtains under section 165. Another suggested area for equivalent treatment involves proposed amendments to exclude from the estate and gift taxes distributions from annuities purchased under qualified plans. A related problem exists with respect to annuities purchased by life insurance companies for their employees. Under section 22 (b) (2) (B) annuity treatment is provided for employee annuities, and the amount of the employer's contribution is not regarded as currently taxable income provided the employer's contribution is deductible under section 23 (p) (1) (B) or, as above, if the annuity is purchased by an employer exempt from taxation under section 101 (6). The contributions of life insurance companies do not fall literally within either of the two classifications since life insurance companies are taxed under the special provisions of section 201 and their contributions are not deductible under section 23 (p) (1) (B). The Bureau, however, has held in a published ruling that these contributions should be similarly treated if they are made in accordance with a plan that meets the requirements of section 165. It has been proposed that specific legislative sanction should be given to this Bureau ruling and that section

22 (b) (2) (B) should be applicable to annuity contracts qualifying under section 165.

One correspondent states that present law puts trusteed plans at a disadvantage as compared to group annuities. It is explained that no provision of law or regulations allows an employer to build up a contingency reserve as protection against future adverse experience with respect to mortality, employee turnover, or other factors which influence costs. It is pointed out that insurance companies, in the operation of group annuities, are able to build up contingency reserves before declaring dividends. Therefore, the suggestion has been made that an employer may allow gains from actuarial experience to remain in the trust fund as a contingency reserve against future losses. It is suggested that a limit could be placed on the amount of such a reserve, perhaps expressed as a percentage of total liabilities or total funded liabilities. The opposite viewpoint has also been expressed. It has been proposed that insurance companies should not be taxed on investment income attributable to pension plans on the theory that to do so gives a competitive advantage to tax-exempt trusts.

It is stated that the taxability of a widow or children under a trust which meets the requirements of section 165 (a) can be unfair. The example is given of a retirement-income policy purchased by an employer for an employee, 30 years old, providing $100-per-month income upon retirement at age 65 with a minimum death benefit of $10,000. It is stated that, if the employee dies during the first year of issue, the entire proceeds of $10,000 are paid to the widow and are free of tax as insurance, but that, if the same employee should die 30 years later, his widow would be subject to tax on the full $10,000 because at that time the cash value would approximately equal the face value of the policy. It is suggested that, in fairness to the older widow, all such income from a qualified trust should be nontaxable.

The burden of establishing that an employee trust qualifies as a tax-exempt trust rests upon the trustee. For this purpose he is required to file with the Bureau a number of documents both in the first year of the trust and, although to a more limited extent, in each of its succeeding taxable years. It is suggested that the requirement for annual information be eliminated with respect to pension plans which have been in operation for several years. Another suggestion along the same line would be to require the filing of information only every third year rather than annually.

Under present law the amount withheld from an employee's compensation as his contribution to a pension plan is included in the employee's taxable income. Upon retirement his pension payments are taxed as an annuity—that is, he is taxed upon 3 percent of the total he has contributed and the balance of the annuity payment is tax-free until the total excluded is equal to the aggregate of his contributions. It is contended that present law in this respect places an undue burden on the employee by taxing him at his highest tax rates on income which is not available to him until future years, and, thus, tends to discourage contributory plans. It is suggested that a more equitable treatment would be provided by exempting contributions and taxing annuity payments in full, thus spreading the tax burden over the period of actual benefit.

It has also been recommended that the benefits of qualified plans should be made available to persons, such as independent sales agents, who do not come within the traditional concept of an "employee" but who economically are dependent upon and contribute to the success of the company in much the same way.

13. Retirement plans for the self-employed

Section 165 of the code provides special tax treatment for a qualified pension plan established by an employer for his employees. This treatment creates three tax advantages with respect to such a plan: (1) The immediate deductibility of the employer's contributions to the plan; (2) the exemption of the pension trust itself from income tax; and (3) deferment of the employee's tax until actual distribution. (For a discussion of such plans, see the preceding section of this report.)

By its terms, the above provision is limited to a plan established for employees. Professional and other self-employed individuals, including members of partnerships, are unable to take advantage of such a retirement program. The major advantage which the employee has over the self-employed in this regard is the fact that he is not taxable currently on the amount of his employer's contribution to the pension fund. He is able to defer tax until retirement on these amounts which are, in fact, in the nature of additional compensation.

A number of suggestions have been received which have the purpose of reducing the present tax barriers which make it relatively difficult for the self-employed individual to provide for his own retirement.

One suggestion is that for the purposes of section 165 partners or individual proprietors be deemed to be employees.

A second suggestion, along the lines of pending legislation, would permit self-employed individuals to exclude from taxable income contributions to a pension fund. Under this type of suggestion, the maximum amount which could be excluded is usually based on the average amount which it is believed employers pay into pension funds on behalf of their employees. As stated by one correspondent, a self-employed individual should be permitted to exclude from taxable income payments into a pension fund with a bank or insurance company which represent "the same percentage of his annual gross income before tax as a corporation might pay, on a basis of no contribution by the employee, into a similar fund for the employee."

Another suggestion would permit the deduction of earned income used for the purchase of annuities, up to a limit of 15 percent of such income or $7,500 a year. Another would simply permit the deduction of insurance premiums paid toward retirement benefits.

One of the reasons advanced by some correspondents for the adoption of plans such as the above is that many professional persons, such as doctors and lawyers, are denied social security protection under present law.

While most of the suggestions in this area deal with the retirement problems of the self-employed, several correspondents recognize that there are many employees whose employers do not maintain a retirement program for their benefit. As a result, it has been suggested that any individual be permitted to make tax-free payments to a retirement fund up to some statutory maximum, provided that the

amount of the allowable deduction be reduced by the amount of any payments made to a qualified pension plan on behalf of the individual by his employer.

14. Medical, dental, and similar expenses (sec. 23 (x))

Under the present law medical and dental expenses are deductible with certain limitations. First, they must exceed 5 percent of the taxpayer's adjusted gross income except in the case of taxpayers or their spouses 65 years of age and over and, secondly, the deduction is limited to $1,250 in the case of a single individual, $2,500 in the case of a single individual with 1 or more dependents, or in the case of a married couple filing a joint return and having no dependents, and $3,750 in the case of a married couple filing a joint return and having 1 dependent, and $5,000 in the case of a married couple filing a joint return and having 2 or more dependents.

Many suggestions deal with the present percentage limitation. A number have suggested that the 5 percent limitation be removed entirely. Another has recommended that the limitation should apply to net income before the deduction for medical expenses (as was true prior to 1944) rather than to the taxpayer's adjusted gross income. Some have proposed that the limitation be reduced to a lower figure such as 2 percent. One correspondent has recommended that there be provided a 2 percent rate for taxpayers with incomes above $5,000 and that for those with incomes below $5,000, all of the medical expenses in excess of $50 be deductible.

A number of other suggestions deal with the maximum amount of allowable deductions. For example, it has been suggested that the present limitations be maintained but that a carryover and carryback be provided for any expenses in excess of the maximum limitation. A proposal has also been made to the effect that single individuals having more than one dependent should not be limited to a maximum deduction of $2,500 but should be allowed the same amount as married persons filing joint returns. A number have suggested that the maximum limitations either be increased generally or removed entirely. In this connection, one correspondent argued that illness is a type of casualty and that, therefore, the full expense should be deductible as is true with respect to casualty loss.

It has been suggested that the extra personal exemption for those 65 years of age or over and the exemption for the blind should be taken into account in arriving at the maximum medical expense allowance.

A suggested plan to facilitate the administration of the medical deduction would involve the use of stamps of various denominations. These stamps would carry the doctor's name and address. When the individual paid his doctor's bill he would be given stamps by the doctor showing the amount of the bill and in claiming the medical expense deduction would attach these stamps to his final return.

It has been pointed out that what constitutes medical care is not clearly defined in the code, and the suggestion has been made that the law be rewritten in more precise terms. Illustratively, it has been stated that such a redefinition should broaden the scope of the present deduction. For example, one taxpayer installed an elevator in his house on doctor's orders for the use of his wife, a cardiac patient, and such expense was disallowed by the Bureau. He believes that such an expense should be deductible as a medical expense.

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Another problem involving the question of what should be the proper scope of the medical deduction concerns the special transportation expenses of the physically handicapped. Present law does not permit any deduction for the expense of transportation to and from work. Such expenses are disallowed on the theory that they are personal and not business expenses, primarily because the location of the individual's place of residence is a matter of personal convenience. However, physically handicapped persons frequently must incur unusual transportation expenses solely by reason of their disability. For example, it may be necessary for such a person to utilize taxicabs rather than cheaper forms of public transportation. As a result, it has been suggested that such transportation costs be deductible as a medical expense. A variant of this proposal would limit such a deduction to the excess of the cost actually incurred over what would be the normal cost of transportation were it not for the existence of the particular disability.

One taxpayer suggested that hospital, medical, and surgical insurance premiums should be eliminated from the allowable medical deductions and that the expenses of such treatment should then be deductible irrespective of whether or not reimbursed by insurance.

A problem apparently exists in cases where a taxpayer must place a mentally deficient child in a special school, sometimes operated by the State, because the child is unable to take advantage of the normal public school program. In such cases, it appears that the parent contributes to the extent of his financial ability toward the cost of the special training. However, these expenses are not allowed as medical deductions nor are they deductible as a charitable contribution, presumably on the ground that they are simply educational expenses. Moreover, if the payments by the parent do not constitute at least half of the expense of the special institutional care, the parent is not entitled to a dependency credit with respect to the child. No specific suggestion is made with respect to the problem other than that the tax law should in some way recognize such expenses as deductible items.

On letter has pointed out that the 5-percent-of-adjusted-gross-income-not-deductible limitation is intended to cover ordinary medical expenses—that is, those expenses which the average taxpayer could be expected to incur during the year as a part of his normal personal expenses. This correspondent suggested that the 5-percent limitation be abolished and that the medical deduction provision be rewritten to spell out the specific medical expenses which would be deductible. Such deductible expenses would, under this suggestion, only include those which could be considered extraordinary. It was suggested that this objective might be reached by allowing only those medical expenses which are evidenced by a doctor's bill or a prescription filled under a doctor's order, eliminating many common expenses allowed under present law, such as for toothbrushes, cough medicine, and so forth.

Another area of difficulty relates to the deductibility of the hospital bills of a decedent. Since the statute provides that medical expenses are deductible in the year when paid rather than in the year when incurred, the medical expenses attributable to the last illness of the decedent may be lost as a deduction. It has therefore been proposed that a deduction should be allowed in the final income-tax return of a decedent for all medical expenses paid within a year after death.

It is maintained that the cost of hospitalization for mental patients far exceeds the cost of treatment for the physically ill and usually continues for a number of years. It is suggested that the law recognize this fact and permit the deduction of such expenses without regard to the present maximum limitations, or, in the alternative, permit the deduction of the entire expense in excess of 10 percent of the taxpayer's adjusted gross income. A further alternative suggested for these cases is to allow such taxpayers an additional maximum allowance of $6,000 in addition to the ceilings provided by present law.

One suggestion has been made that the expense of institutional care for invalid dependents should be permitted as a charitable deduction rather than as a medical expense. This suggestion would remove the present 5-percent limitation with respect to such expenses. Finally, a somewhat similar suggestion would permit the deduction of the cost of hearing aids and accessories as business rather than as medical expenses. This would have the dual effect of avoiding the 5-percent limitation as well as permitting the taxpayer to utilize the standard deduction in addition.

It has been suggested that veterinary expenses be permitted to qualify for the medical deduction.

15. Optional standard deduction (*sec. 23* (*aa*))

The present law allows taxpayers with adjusted gross income of $5,000 or more an optional standard deduction of 10 percent of the adjusted gross income limited to $1,000 in the case of a single person or a married couple filing a joint return, and $500 for each spouse when a married couple files a separate return. Those taxpayers with adjusted gross income of $5,000 or less must use the tax table to avail themselves of this optional standard deduction which in this case is approximately 10 percent of their adjusted gross income. This standard deduction is in lieu of itemizing such personal deductions as medical and dental expenses, contributions, interest on personal indebtedness, taxes, bad debts, casualty losses and thefts, alimony, depreciation, and so forth. (See Adjusted Gross income, p. 19.)

A number of replies to the questionnaire suggested that the standard deduction be only in lieu of contributions, interest, taxes, and medical expenses, and that the other personal deductions be allowed as deductions from gross income. This would permit the deduction of expenses which are somewhat in the nature of business expenses, but which are not deductible in arriving at adjusted gross income if the taxpayer is an employee. Others have suggested that the standard deduction as it relates to the charitable contributions deduction is unfair because some people may not make any contributions and still get the 10 percent deduction, while others may contribute substantially but only get the 10 percent deduction. They, therefore, suggest that contributions should be a deduction in arriving at adjusted gross income. Others suggest that the standard deduction be limited to 5 percent of adjusted gross income on the ground that this figure would more closely approximate the actual allowable deductions of the average taxpayer. It has been pointed out that under the present law 2 single people earning $10,000 or more are each allowed a standard deduction of $1,000. This makes their combined standard deduction $2,000. If they marry, their standard deduction is cut in half and reducted to $1,000. It is suggested

therefore that the $1,000 be increased to $2,000 for a married couple. Others suggest the entire elimination of the standard deduction. One correspondent suggested that the standard deduction should be a more realistic figure and suggests that 10 percent be allowed on incomes up to $10,000 and possibly 8 percent or a smaller figure than the 10 percent be allowed those taxpayers over $10,000. One taxpayer suggested that the maximum standard deduction of $1,000 be raised to $1,500, as this would be more in line with present price levels.

16. Research, development, and exploration expenses (sec. 23 (ff))

In general, the deductibility of research and development expenditures turns upon whether the expenditures can be deemed attributable to a process, patent, or other intangible asset of relatively definite useful life. In such instances the research and development expenditures are required to be capitalized and amortized over the life of the intangible asset.

A statement on April 4, 1952, by the Commissioner of Internal Revenue before the Joint Committee on Internal Revenue Taxation indicates that current Bureau policy is to permit the deduction of research and development expenses from current income if the taxpayer has an established accounting practice of so treating such expenditures. The deduction is not extended, however, to buildings and equipment which have a useful life beyond the annual accounting period and which are adaptable to use for purposes other than for research and development on a specific project.

It is suggested that the deductibility of research and development expenditures should be governed by statute rather than by administrative policy and practice. The present statement of Bureau policy is deemed inadequate to provide for research and development projects undertaken by new business or by old businesses with no established practice for accounting for such expenditures. It is urged that the taxpayer should be granted the option to charge off such expenditures currently or to capitalize and amortize over whatever period the taxpayer may elect.

The Revenue Act of 1951 gave taxpayers an option to deduct currently or to treat as deferred expenses mine exploration expenditures up to $75,000 a year for 4 years. It is stated that the present allowance is insufficient and that it creates difficult problems of differentiation between exploration expenditures (which are subject to the limitation) and development expenses (which are deductible in full). It is suggested that the present limitations on mine exploration expenditures be removed. Others have suggested that exploration expenditures incurred by a subsidiary should be allowed as a deduction from the parent corporation's income. Moreover, the present allowance with respect to mine exploration expenditures has been used as an argument for the extension of similar treatment to research and development expenses generally.

Another suggestion has been that exploration expenditures in the case of oil and gas properties should be allowed as a current deduction at the taxpayer's option.

It has been proposed that farmers be allowed to deduct the expenses of developing their property, such as for roads, fences, and irrigation ditches.

17. Taxpayers' residences, repairs, etc.

(For a discussion of the nonrecognition of gain in cases involving the sale of a personal residence and reinvestment of the proceeds in a new residence, see p. 78.)

While present law provides that any gain realized from the sale of a residence is taxable, no deduction is permitted in the event of a loss from such a sale. It has been suggested that such a loss should give rise to a deduction.

The home owner is permitted, under existing law, to deduct any property taxes he must pay with respect to a residence and any interest paid with respect to a mortgage on his property. Persons who rent rather than own their home receive no equivalent deductions. It is argued that this situation represents a discrimination against renters as a class, and it has been suggested that rent should be deductible at least in part. A comparable suggestion recognizes that the renter of residential property pays indirectly as part of his rental the property taxes and interest charges of the landlord. Therefore, it is contended that such indirect payments of taxes and interest should be allowed as deductions to the lessee.

Present law does not permit any deduction for the cost of repairs on a personal residence. One suggestion would permit the deduction of such expenses in their entirety and another would permit the deduction of some fixed percentage of net income for expenses actually incurred for the maintenance of a home. A landlord is entitled to a deduction for the expenses of redecorating or repairing rental property, and it has been suggested that if such expenses are assumed by the tenant they should be allowed as deductions to the tenant.

18. Funeral and burial expenses

Under present law funeral and burial expenses are not deductible for income-tax purposes.

The suggestion has been made that funeral and burial expenses be fully deductible. Another suggestion would limit the deduction to $1,000. Others would limit it to a deduction of $600 as is now allowed by the District of Columbia.

19. Uniforms and work clothes

At the present time, the Treasury holds that expenditures for the purchase and upkeep of employees' uniforms (as distinguished from work clothes) are deductible expenses. It imposes two conditions, however, for deductibility: (1) The uniform must be of a type specifically required as a condition of employment and (2) the uniform must not be adaptable to general or continued usage by taking the place of ordinary clothing. For example, military uniforms, though required, would not qualify since they can be used for ordinary wear. Similarly, the cost of uniforms which can be easily converted to ordinary clothes, such as some railroad conductors' uniforms which are really blue suits with gold snap-on buttons, would be nondeductible.

Despite its allowance of a deduction for the cost of uniforms, the Treasury continues to hold that the cost and upkeep of work clothing are nondeductible personal expenses. The courts, however, in numerous cases have allowed an expense deduction for work clothes even where the employer does not require them to be worn. It has been

stated that deductions for work clothes are frequently disallowed because of inadequate taxpayer records to support the deduction. In order to correct this situation, it has been suggested that taxpayers receive a special standard deduction representing the average cost of work clothes.

In general, the complaints received concerning the deduction for the expense of uniforms and work clothes relate to the existing uncertainty of the law and regulations in this field, and the need for clarification is emphasized. For example, it has been suggested that the law spell out the type of work clothes and uniforms which may be deducted. On the other hand, to eliminate some of the difficulty that the Bureau experiences in drawing the line on deductions for work clothes, it was suggested that these deductions be handled by specific jobs rather than by type of clothing.

20. Life-insurance premiums

The present law does not allow a deduction for life-insurance premiums, and it has been suggested that a deduction up to a reasonable amount be allowed for such expenses. Others have suggested in this regard that the tax laws recognize the unusually high premiums which are paid by "high-risk" individuals such as airplane pilots.

21. College and educational expense

Under present law, college and other educational expenses are not deductible except when incurred as a business expense. A deductible business expense in this area might include the cost of attending professional society conventions and the cost of training courses required by an employment contract. In the latter connection, such a deduction appears to be allowable only where the training in question is required to maintain the taxpayer's present employment. No deduction is allowed where the additional training is undertaken by the taxpayer for the purpose of improving his position or qualifying for other employment.

A number of replies to the questionnaire have suggested a complete deduction for the expense of attending an institution of higher learning, while others, in recommending the allowance of such expenses, would limit the deduction to some fixed dollar amount per year, such as $1,000. Some have suggested that if such a deduction were granted it should be limited to the educational expenses proper, such as tuition and books, excluding living expenses. One suggestion would permit the deduction of the cost of advanced occupational training only with respect to certain specified occupations in which there appear to be shortages of trained personnel.

Instead of recommending the current deduction of educational expenses, some have suggested that such expenses be capitalized and written off over a period, such as 10 years, following graduation. Along the same line, it has also been proposed that expenses for advanced education be amortized over the expected lifetime of the individual.

Under the present law a parent loses the dependency exemption when the dependent earns $600 or more. A number of the replies suggested that the parent be allowed the dependency exemption as long as the dependent was under 25 years of age and attending school no matter what the income of such dependent amounted to. Others

suggested that the parent still be permitted the dependency exemption as long as the student did not earn over $1,000, while others have suggested the parent be allowed a deduction for at least a portion of the educational expenses of a child.

22. Filing fees for political office

It has been suggested that where candidates for political office are required by State statute to pay filing fees to get on the ballot or are required to bear any of the costs of primary elections, such expenses should be deductible from gross income.

23. Tax litigation expense

Individual taxpayers may deduct legal fees and expenses of litigation under present law if such expenditures are incurred in the production or collection of income or in the management, conservation, or maintenance of property held for the production of income.

Thus litigation expense incurred in connection with income-tax deficiencies is regarded as deductible but litigation expense incurred in connection with gift-tax deficiencies is not.

It is urged that the legitimate cost of contesting any tax liability should be deductible.

24. Reserves for contingencies

In general, deduction of reserves for contingent liabilities is not permitted. A statutory exception is made for reserves for bad debts. When reserves are set up on the books to provide for anticipated expenses, deduction is not permitted until the liabilities actually accrue and are charged to the reserve.

It is stated that present law and regulations prohibiting the deduction of reserves for contingencies are contrary to accepted accounting practices. It is recommended that the deduction of reserves for contingencies should be permitted.

25. Miscellaneous deductions

One correspondent has suggested a limitation on the deductibility of business losses. He recommends that taxpayers should not be allowed to offset losses from one type of business against gains and profits in another, pointing out that under present law a taxpayer can offset the income from a profitable business by losses from such an enterprise as a "hobby" farm.

Another has suggested a change in the tax treatment of expenditures for faulty construction. Under present law, as interpreted by the Bureau of Internal Revenue and the courts, where, during the construction of a building or other property, expenditures are made for construction which is faulty or otherwise unsuitable and that construction is demolished or changed, the expenditures for such useless construction and for demolishing it are held to be a part of the capital cost of the ultimate changed structure, not deductible except through depreciation or amortization of the entire cost. It is suggested that the law should be changed to permit the current deduction of the costs of constructing and demolishing any portions which do not become a part of the final structure, since, it is argued, such expenditures result in nothing of permanent value and thus constitute a loss.

Another suggestion deals with old structures that are razed to make way for new buildings. The tax problem in this instance pertains to allocation of the demolition costs rather than to deduction from current income as in the proposal above. Under present law, the costs of old structures which are razed, together with their demolition costs, are regarded as part of the purchase price of the land if the taxpayer has acquired the property with the intent to raze the structures thereon. It has been proposed instead that the costs attributable to the old structures and to their demolition should be added to the cost of any new building erected on the property so that these costs can be recovered through the depreciation allowance.

The question of the deductibility of repair parts has also been raised. Under present law the cost of repair parts and supplies are generally not allowed as a deduction until placed in service. It has been proposed that the taxpayer should be given the option to deduct these repair parts and supplies either in the year purchased or in the year placed in service.

It has been stated that, if taxpayers were allowed a deduction of 10 percent or 15 percent of their income if invested as risk capital or in job-making enterprises, it would increase and stabilize business.

It has been suggested that it would be desirable to allow small, individually owned hospitals to plow back part of their profits for needed additions and equipment and that such amounts should be a deduction from gross income.

E. ITEMS NOT DEDUCTIBLE (SEC. 24)

1. Allocation of expenses attributable to taxable and exempt income

Section 24 (a) (5) prohibits the deduction of any amount otherwise deductible which is allocable to one or more classes of exempt income. It is stated that where the income of a trust consists in part of exempt interest on municipal bonds and in part of taxable dividends and interest on a great variety of securities any allocation of the commission paid the trustee on the basis of the respective amounts of taxable and exempt income is unrealistic, since relatively far more time is spent on the taxable securities than on the municipal bonds. It is suggested that the commission paid the trustee should be fully deductible whether or not the trust receives any exempt interest.

2. Disallowed losses (sec. 24 (b))

Losses on sales or exchanges between related taxpayers or between a taxpayer and a related corporation are disallowed by section 24 (b) (1). This provision has been construed by the courts to deny deduction of losses while taxing gains when a number of items are transferred between related taxpayers as part of a single transaction.

It has been urged that present law is unduly harsh in two respects:

(1) The disallowance should be limited to net losses on transactions between related taxpayers instead of the present rule of disallowing all losses and taxing all gains.

(2) The transferee should be permitted to take the transferor's basis for purposes of computing gain. Under the present rule the transferee may be taxed on a gain even though he sells the property for less than the transferor's basis.

3. Accrued unpaid expenses (sec. 24 (c))

Accrued expenses or interest owing to a related taxpayer may not be deducted by a taxpayer, even though he keeps his accounts on the accrual basis, unless (1) paid in the taxable year or within 2½ months thereafter, or (2) the amount accrued is includible in the gross income of the related taxpayer for the year in which the taxable year of the taxpayer ends.

Thus, if a calendar year taxpayer accrues an item of expense but does not pay such amount to a related cash basis taxpayer until after the following March 15, the deduction is lost for both the year of accrual and the year of payment. This result would still obtain even though the amount should be held constructively received by the related taxpayer (and therefore taxable to him) at any time after December 31.

It is urged that present law operates unfairly, especially where the taxpayer is denied the deduction even though the related taxpayer is taxable on a theory of constructive receipt.

It is recommended that deductions be allowed in the year of payment of accruals in favor of related taxpayers. Another suggestion is to allow such accruals to be deducted in the year of accrual provided the related taxpayer elects to include such amounts in income for a coinciding taxable year.

F. PERSONAL EXEMPTIONS, CREDITS FOR DEPENDENTS, AND CREDITS GENERALLY

1. Personal exemptions and credits for dependents (sec. 25 (b))

The present per capita system of exemptions was first adopted in 1944. The Revenue Act of 1948 continued this system but increased the amount of the exemption from $500 to $600. Also in 1948 an extra $600 exemption was provided for those taxpayers 65 years of age and over. That act also changed the then allowable deduction of $500 to an exemption of $600 for the blind. A $600 credit is also allowed with respect to each dependent of the taxpayer. These provisions have not been changed by any subsequent revenue act.

Among the more general changes that have been recommended are those that would increase the per capita exemption from $600 to various amounts ranging from $700 to $1,200. Another suggestion relating to the level of exemptions would increase the amount to $1,032. supposedly representing the devaluation of the dollar since 1940, or. alternatively that the amount of the exemption be geared to the Consumer's Price Index. Suggestions have also been made to increase the exemption for a married couple from $1,200 to $2,500 and the exemption for a single person from $600 to as much as $2,000. It was also suggested that single persons without dependents be allowed an additional exemption, such as $300 or $600. There have also been recommendations for the grant of additional exemptions to certain special groups, for example, persons aged 80 or over, persons 75 percent or more disabled, those afflicted with multiple sclerosis, diabetes, or poliomyelitis. A contrary suggestion would eliminate the present additional exemption for those aged 65 and over, and it has also been suggested that a man on strike and dependent on Government relief should be required to reduce his exemption by the amount of relief he receives.

At present a taxpayer who has a net loss in one year and a relatively high income in another year may offset some of his deductions in the loss year against the higher income of another year by means of the net operating loss carryback and carryover, but he cannot offset the exemptions of the loss year against the income of another year, and any excess of exemptions over income in one year cannot be offset against an excess of income over exemptions in another year. Therefore, it has also been proposed that a new term be added and called "an unused exemption deduction." This would be defined as the excess of exemptions for the taxable year over the net income for the taxable year.

As was true with respect to the per capita exemptions, many of the suggestions relating to the credit for dependents recommended various increases in the present $600 amount. These increases range up to $1,000 per dependent. Some have suggested the introduction of some economic basis for determining the proper amount of the dependency credit. In this connection, one correspondent pointed out that New York City foster home organizations offer to those who will take a foster child into their home $720 a year plus all medical and clothing costs. Another taxpayer has suggested that the dependency credit be graduated in accordance with the age of the dependent, for example, $600 up to the age of 9 or 10 and $1,000 after that time up to the age of 21.

One taxpayer who suggested that the dependency credit be raised to $1,000, thus eliminating from the tax rolls a large number of taxpayers who have dependents, also suggested that the first bracket tax rate be increased to 25 percent.

A number of suggestions were received which deal with the allowance of additional dependency credits rather than an increase in the present amount. For example, it has been suggested that widows or widowers be allowed an additional $600 credit for each dependent. A similar suggestion relates to a head of household who believes that he should be given the same treatment as a married couple. He points out that a husband is allowed an additional exemption if his wife is aged 65 or more, but that a single person who supports an aged person who is over 65 is not allowed such an additional exemption. In fact, a number have recommended that taxpayers who have dependents over age 65 be granted an additional dependency credit. This is supported on the ground that the aged individual himself, if he were a taxpayer, would be entitled to a double personal exemption. Other additional dependency credits have been recommended with respect to taxpayers whose children are either mentally or physically subnormal.

It has also been suggested that instead of allowing a personal exemption or credit for a dependent as a deduction from adjusted gross income these exemptions or credits be deductions from the tax, at the basic or first bracket rate of 22.2 percent as is done by some States. Thus, at present rates, there would be in each case a tax reduction of 22.2 percent of $600, or $133.20. It is argued that this system would give the same tax advantage for exemptions to all taxpayers irrespective of their tax bracket.

It has been further proposed that taxpayers with dependents residing in foreign countries should be allowed the dependency exemption, as was formerly true.

2. Definition of dependent (sec. 25 (b))

The present law defines a dependent as one of the following persons over half of whose support is furnished by the taxpayer and who does not earn as much as $600 in the taxable year:

(*a*) A son or daughter of the taxpayer, or a descendent of either.
(*b*) A stepson or stepdaughter of the taxpayer.
(*c*) A brother, sister, stepbrother, or stepsister of the taxpayer.
(*d*) The father or mother of the taxpayer, or an ancestor of either.
(*e*) A stepfather or stepmother of the taxpayer.
(*f*) A son or daughter of a brother or sister of the taxpayer.
(*g*) A brother or sister of the father or mother of the taxpayer.
(*h*) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer.

As used in this paragraph, the terms "brother" and "sister" include a brother or sister by the halfblood, and, for the purposes of determining whether any of the foregoing relationships exist, a legally adopted child of a person is considered a child of such person by blood.

Prior to the enactment of the Individual Income Tax Act of 1944 the law did not provide an income test nor a blood relationship test. At that time a taxpayer was entitled to a dependency exemption if he provided a person's chief support and such person was either (*a*) under 18, or (*b*) incapable of self-support because of mental or physical disability. Relationship between the taxpayer and such person did not matter except in the case of husband and wife.

Four principal types of problems have been presented in reply to the questionnaire. These relate to the blood relationship test, adoption, the income test, and the amount of the exemption that should be allowed dependents over 65 years of age.

The blood relationship test has been criticized on the basis that foster children cannot be claimed as dependents. In addition to foster children generally, the question was raised regarding children awaiting adoption where the dependency credit is disallowed until the final court decree; that is, the credit is not allowed during the so-called waiting period, which may run for a considerable length of time. In New York State this waiting period is 2 years. The suggestion has been made that a foster son or daughter of the taxpayer during such a waiting period be deemed to meet the relationship test. A further suggestion in this area would provide that the parents could file an amended return after the final court decree, and claim the dependency exemption retroactively for the waiting period. Another case involving the blood relationship test was presented by a taxpayer who raised the children of the sister of his deceased wife. The uncle raised the children, is sending them to college, but has not been allowed the dependency credit since 1943 when the law was changed. This result follows from the fact that the children are not nephews or nieces by blood and this taxpayer therefore suggested that the simplest solution would be to abolish the blood relationship test and restore the pre-1944 provisions in part.

It has been suggested that the $600 gross income test be amended and that the test be based on adjusted gross income. An example was cited where a dependent has rental income in excess of $600 (gross income), but his adjusted gross income after the deduction from gross income

of his interest, taxes, depreciation, etc., is less than $600. The exemption is, therefore, lost to the taxpayer in this case even though the dependent meets the other dependency tests. Another case of this type involved a dependent who had capital gains in excess of $600 and was required to include 100 percent of the gain in his gross income. (This change was made in the 1951 Revenue Act.) His adjusted gross income, after taking into account only 50 percent of such gains, was less than $600. Again the dependency credit was lost.

Numbers of letters have suggested that the $600 income test be increased to $800, $1,000, or as much as $1,200 or $1,500. Taxpayers seem to find that a dependent working during the summer or after school has little trouble earning as much as $600. Therefore, the parent loses the exemption, and any number of correspondents stated that they stopped their children from working when their income amounted to nearly $600. There have been some suggestions that, if the earnings test is increased to some higher amount, such as $1,200, before the parent loses the dependency credit, the dependent should still be required to file a return and pay tax on the excess of his earnings over $600, as under present law.

The recommendation was made that a wife be treated in the same manner as a dependent insofar as her income is concerned; that is, the first $600 of earnings of a wife should not be includible in her husband's income.

Under the present law, where several children combine to share the support of a parent and neither child furnishes over half of the support, none of the children is allowed the exemption. It is suggested in such cases that the $600 exemption be apportioned to each child in relationship to the amount contributed by such child to the support of the parent. It was further suggested that so long as no other person claimed the dependency credit and some contribution was made, then the full dependency credit should be allowed for such contribution. One suggestion would allow parents to claim the dependency credit for a portion of the year where they meet all the tests. (This is allowed in the State of Oregon.) A suggestion was made that a deduction should be allowed for contributions made to aged or ailing relatives who for one reason or another do not meet all of the dependency tests.

A considerable number of letters were received from taxpayers who felt that where they supported a parent or any other dependent who was 65 years of age or older an additional $600 exemption should be allowed for such dependent. The comparison was made in most of the letters that in such a case this dependent was no different than the wife over 65 of a taxpaying husband where in such case the husband, whether 65 years of age or not, is allowed an extra $600 exemption for the wife which results in a tax differential of $133 on a $2,500 income.

3. Working wives, widows, and widowers

The present law does not provide any extra exemption, deduction, or relief of any kind for a working wife, widow, or widower. There is one exception and that is in the case of the split-income benefit available to a married couple or the head of a household.

A large number of letters have recommended some type of special tax treatment in the case of an employed individual who must, because

of his or her employment, incur an expense for the supervision of dependents while absent from home. Such expenses include both those incurred with respect to the hiring of domestic servants and those incurred where the taxpayer places a child in a nursery school, or similar organization, during working hours. Implicit in practically all of these suggestions is the argument that such expenses would not be incurred except for the fact of the taxpayer's employment. Thus, the proposal that these expenses be recognized as legitimate deductions is based on the proposition that they are essentially in the nature of business expenses.

Most of the suggestions in this area are limited to cases involving child care and supervision. However, some recognize that a similar problem exists in the case of invalids, or other dependents who are not able to take care of themselves and with respect to whom some type of help must be employed. Many of the suggestions deal with the case of the single parent, that is, the taxpayer who is either widowed or divorced and who ordinarily must seek employment for the purpose of support. Therefore, while some of the proposals would grant special tax treatment in cases where both parents are living together and both are employed, a number have recommended that such treatment be limited to the case of the single parent.

The nature and the extent of the relief recommended are of various types. Some recommend the relatively simple expedient of granting an additional personal exemption to the taxpayers in question. Under one such suggestion, the additional exemption would be available to working wives, widows, and widowers. A similar suggestion would extend to widows or widowers one additional $600 exemption with respect to one dependent and an additional $300 exemption for each other dependent, such allowances being intended to compensate for the expenses of child care and supervision. Another related suggestion in this area would double the existing dependency credit for widows or widowers with respect to each dependent child who is under the age of 16 whose sole support is furnished by the taxpayer.

The bulk of the suggestions in this area would relate the amount of the deduction to the amount of expenses actually incurred, with the frequent suggestion that some maximum be imposed on the amount allowable. The most common suggestion would allow a deduction for the actual expenses of child care up to some fixed statutory amount. Examples of such suggestions are: actual expenses not to exceed $600 or 25 percent of the taxpayer's gross income, whichever is the lesser; actual expenses up to a total of $200; expenses not to exceed a weekly maximum such as $20 or $25; expenses up to 25 percent of the adjusted gross income of the parent or parents, not to exceed $1,500 for one child and $3,000 for two or more children; expenses not to exceed 50 percent of the working wife's income; apply limitations similar to those applicable with respect to medical expenses, that is, permit a deduction only for those expenses in excess of 5 percent of the taxpayer's adjusted gross income. One suggestion recognized that the present dependency credit of $600 is intended to compensate, in part at least, for the expense of child care and proposed that the additional deduction should only be applicable to those expenses which exceed $600 per child. Some correspondents would permit an unlimited deduction of the expenses of child care.

Moreover, an even broader proposal, apparently not limited to cases of child care, would permit the deduction by single taxpayers of any wages and salaries paid for domestic help, provided that such wages and salaries are reported and taxed under the Social Security Act.

Along with limitations described above which relate to the amount of the deduction that would be allowable, various proponents of special tax treatment in this area would limit the availability of the treatment to taxpayers who have less than some specified amount of income. For example, one would limit the availability of a deduction to cases where the total family net income does not exceed $4,000 per year. Another suggestion would place such a limit at $4,500, while still another would limit the deduction to single people with children provided the taxpayer's income is not in excess of $10,000.

Another type of limitation which recurs among the suggestions are those which would limit the special tax treatment to cases of child care involving children of less than some specified age. In one case this was 13 years of age, 16 years in another.

The determination of the amount of applicable expenses received attention from several correspondents. One recognized that domestic help hired to take care of children when the parent is absent frequently perform other services, such as housecleaning and preparation of meals for the taxpayer himself, which represent personal living expenses unrelated to child care. As a result it has been suggested that the amount of the deduction should not include expenses for ordinary household work or for child care during other than the normal working hours of the taxpayer. Some would relate the deduction to the actual number of hours of child care per day. In this connection, one correspondent suggests that the tax return provide a space showing the total number of hours worked by the taxpayer during the year, the taxpayer's hourly income and gross pay, followed by a statement of the total number of "deductible child-care hours, average hourly expenses, and total allowable expense." The "allowable-care" hours would be defined under this suggestion as those hours of supervisory care actually incurred as a direct result of the taxpayer's working for compensation, the total of such hours not being permitted to exceed the total working hours. However, at least one correspondent believes that to base the amount of the deduction upon actual expenses incurred would not be feasible as it would involve too intricate an accounting problem for the average housewife. As a result, it was stated that some flat amount be allowable in such cases, and reference was made to the present North Carolina income tax law as a possible solution. Under this proposal, a head of household would receive a special exemption of $2,000 plus $600 for each dependent other than a wife or housekeeper. The other spouse, if an income earner, would receive a $1,000 exemption and could elect to take credit for some of the dependents by agreement between the couple.

Correspondents differ as to the method by which the suggested deduction should be taken on the income tax return. For example, some suggest that it be a deduction from adjusted gross income while others speak of it as a deduction from gross income because they consider it a business expense. If the latter procedure were adopted, it would

permit a qualifying taxpayer to take a deduction for child care without losing the benefit of the standard deduction.

While most of the suggestions in this area are limited to cases of child care, it has also been recommended that some additional relief should be provided for single people generally who maintain a household.

4. Treatment of earned income

A few suggestions have been received that some type of preferential tax treatment be extended to earned income, as distinguished from investment income. The tax law at one time gave an earned income credit against net income for purposes of the normal tax. The credit was equal to 10 percent of the taxpayer's earned income, excluding from the computation any earned income in excess of $14,000. Thus, the amount of the credit could not exceed $1,400. All income up to $3,000 was presumed to have been earned. One correspondent has recommended that a similar credit be reinstituted today. Under this suggestion, all income up to $5,000 would be deemed to have been earned and a ceiling of $2,500 would be placed on the amount of the credit.

Another suggestion in this area would create a special overall tax rate limitation of 50 percent with respect to earned income. Another correspondent has suggested a ceiling of 60 percent on salaries, wages, and short-term capital gains.

It has also been recommended that persons aged 75 and over be completely exempt with respect to their earned income.

Another proposal in this general area would allow a credit of varying percentages of earned gross income. These percentages would be graduated in accordance with the taxpayer's age, for example, a 1 percent credit at age 21 graduated to 25 percent at age 60. This suggestion is supported on the ground that it would increase the opportunities for a wage earner to provide for his own security following retirement.

5. Double taxation of corporate dividends (sec. 26 (b))

Corporate dividends under present law are taxable in full to noncorporate shareholders, and no deduction for dividends paid is allowed the corporation. Corporate shareholders are given an 85-percent dividends-received credit for dividends received from another domestic corporation or from certain foreign corporations doing business in the United States.

At the corporate-shareholder level it is urged that the dividends-received credit should be increased to 100 percent. There is no logical justification, it is said, for limiting the dividends-received credit to 85 percent. Other corporate shareholders suggest that the dividends-received credit should be changed to an exclusion from gross income. In its present form of a credit against tax the dividends-received credit operates to deprive corporations with a large amount of dividend income of the full tax benefit of a net operating loss carry back or carry forward.

At the non-corporate-shareholder level, it has been urged that present law fails to give recognition to the corporate-income tax to which corporate earnings are subject before they are available as distributions to shareholders. Thus, corporate dividends are said to be sub-

ject to double taxation. Where the earnings are those of a subsidiary corporation, there is triple taxation to the extent of the tax paid by the parent corporation on 15 percent of the dividends it receives from the subsidiary. Another fundamental objection that has been raised to the provisions of present law is that an undue tax advantage is given to the use of debt capitalization, rather than equity financing, in corporate structures. Interest paid on debt capital may be deducted from gross income whereas dividends paid on equity capital are not deductible.

Most of the suggestions relating to double taxation of dividends emphasize the importance of making some attempt at solution of the problem even if only in a limited way. Several have indicated that, while the long-range objective should be the complete elimination of the double taxation aspect, this approach might not prove feasible at the present time because of revenue considerations. One suggestion is that the complete elimination of the double tax could be accomplished at the shareholder (noncorporate) level by the "grossing up" principle. In brief, this would mean that a corporation in each dividend distribution would determine the amount of its corporate tax that was borne by the corporate earnings thus distributed as a dividend. The taxpayer-shareholder would then include in gross income, along with the dividend received, the amount of the corporate tax so attributable. He would then receive a tax credit for the latter amount. As indicated, however, the complete eliminate of the double tax in this manner is believed by many not to be expedient at this time. In lieu of the above proposal, many have suggested that noncorporate shareholders be given a limited credit for dividends received. Some would make this credit as high as 30 percent of the total dividends received. Others suggest a percentage of 22.2 percent which would eliminate double taxation at the first income bracket. Others have proposed 20 percent. The largest number of suggestions of this type, however, have recommended 10 percent as the proper proportion. Some have recommended that withholding on dividends be provided, at say a 20-percent rate, and a credit be allowed the shareholder of double the tax so withheld. It has been suggested that such withholding might partially offset the revenue loss resulting from the credit itself.

A somewhat different approach to the problem but one still designed to eliminate the double tax at the shareholder level is the suggestion that noncorporate shareholders be permitted to exclude dividends received up to a maximum of $200 from taxable income. Others would go even further and include in taxable income only 15 percent of all dividends received. One individual suggested that if a corporation is subject to the excess-profits tax any dividends paid in that particular year should be exempt from tax at the individual level; and where a corporation does not pay excess-profits tax, any dividend distribution should be taxed at a maximum rate of 30 percent at the individual level. Another correspondent stated that where a corporation has paid an income tax, the remaining income should be treated as capital and when received by the stockholder should be used to reduce the cost or other basis of his stockholdings in the corporation. Another wrote that dividends in the hands of individuals should not be taxed in excess of a rate representing the excess over the top bracket rate of the individual and the top rate paid by the corporation. Others

suggested that recipients of dividends should be taxed thereon under the capital-gains provision. Therefore, if they held the stock 6 months or longer they would be taxed on only 50 percent of the distribution or at a maximum rate of 26 percent, but if held less than 6 months they would pay the regular income tax.

A number of correspondents approached the double-taxation problem at the corporate level. Many of these expressed concern over the difference in tax treatment given dividends as compared with interest. Some would give corporate taxpayers a dividends-paid credit for all dividends paid, or permit corporations to consider dividends paid as an allowable business expense which could be deducted from gross income. A variant of this proposal advanced by one correspondent would permit corporations to deduct dividends paid to shareholders and would impose a special tax on retained earnings in excess of 10 percent of net worth. Others would also permit dividends to be deducted by the corporation as a business expense but would limit the deduction to a maximum of 4 percent of the net worth of the corporation. Still others would base the maximum limitation on a special dollar amount, with suggestions as to the maximum ranging from $50 to $100,000. Some have expressed the belief that dividends paid should be considered an expense to the corporation in inverse ratio to the size of the corporation—for example, a very large corporation might be allowed a deduction of 10 percent of dividends paid, whereas very small corporations would be allowed a 50-percent deduction. One taxpayer advanced the idea that all stockholders be placed on salary by their respective corporations so that the corporations could deduct the salary payments as business expense.

Certain businesses, such as utilities and national banks, have indicated that their problem of attracting equity capital is made difficult by the regulation to which they are subject. A special dividends-paid credit or dividend exclusion for stockholders of such regulated industries has been suggested.

One correspondent has suggested that the double-taxation problem can best be solved by taxing corporations as partnerships and requiring the shareholders to bear the corporate tax both on distributed and accumulated earnings.

G. DECLARATIONS, WITHHOLDING, FILING OF RETURNS, AND PAYMENT OF TAX

1. Declarations of estimated tax (secs. 58, 59, and 60)

The present law divides individual taxpayers into two groups insofar as the requirements for filing a declaration of estimated tax are concerned. These are as follows: (1) Wage earners and salaried individuals with gross income not in excess of $100 from other sources (including wages not subject to withholding) are required to file declarations if their gross income from wages or salaries is in excess of $4,500 plus $600 with respect to each of the exemptions, or (2) individuals with gross income in excess of $100 from sources other than wages and salaries subject to withholding are required to file declarations if their gross income (including income from wages or salaries) is in excess of $600.

The present law also provides certain penalties for failure to file a declaration or failure to pay the estimated tax on time. These are as follows:

(1) For failure to file a declaration on time or for failure to pay the estimated tax on time, the penalty is 5 percent of the unpaid amount of each installment due plus 1 percent for each month or part of a month (except the first) during which such amount remains unpaid, up to a maximum of 10 percent of the unpaid amount of such installment.

(2) The penalty for an underestimate of tax by more than 20 percent by January 15 of the succeeding year is 6 percent of the entire shortage in the estimate but not more than the amount by which the estimate falls short of 80 percent of the tax (or in the case of farmers 66⅔ percent of the tax). This penalty does not apply if the estimated tax for the current year is computed on the basis of the income of the preceding year and the personal exemptions and credit for dependents for the current year, provided it is paid in quarterly installments on time or ahead of time (or in the case of farmers is paid in full on or before January 15 of the succeeding year).

(3) If no declaration is filed, the taxpayer is subject both to the penalty under (1) for failure to file and to the penalty under (2) for an underestimate. In such case the estimated tax is deemed to be zero.

A number of suggestions have been received which relate to the March 15 filing date for declarations. It appears that a number of taxpayers would prefer to have this date moved up to April 15, changing the date for filing the final return to the same date. On the other hand, one individual has suggested that the March 15 filing date be retained but that the tax be divided and paid in 3 equal installments (rather than 4 as under present law); that is, in June, September, and January. Some have suggested that the January 15 date for the filing of the final amended declaration be changed to January 31, others suggesting February 15. Another proposal is that taxpayers be allowed, at their option, a 3 months extension for filing declarations, subject to 6 percent interest. It has also been suggested that any extension of time for the filing of a final return should automatically carry with it an extension of time for the filing of a declaration. In order to encourage the early payment of tax and, thus, the spreading of the administrative task of the Government, it has been suggested that if a final return is filed in January and tax paid in full at that time, the taxpayer should receive a discount of one-half of 1 percent. Under this suggestion, a smaller discount would be granted for payment in February and, of course, no discount for payment on the due date.

Under present law, farmers may make their declaration at any time on or before January 15 of the succeeding taxable year, instead of at the time required of other taxpayers. Thus, a calendar year nonfarmer taxpayer having the required amount of estimated gross income would have to file his declaration by March 15, while a farmer could wait until January 15 of the succeeding year. In addition, if a farmer files his return by January 31 of the succeeding year, and pays the tax due, the return will eliminate the necessity for filing any declaration of estimated tax. If a declaration was filed, the return will act as an amended declaration. It has been pointed out in this connection that, in Michigan, logging and farming are considered related indus-

tries because each produces a seasonal crop. Therefore, it has been suggested that loggers should be given the same privileges as farmers insofar as filing requirements are concerned. Another suggestion would treat all taxpayers the same as farmers with reference to the January 15 filing date, this proposal being particularly common with respect to individuals in business. However, a number have criticized the present special treatment of farmers and state that they should be required to either estimate their tax by July 1, under one suggestion, or pay a given percentage of the previous year's tax, under another. These proposals are supported on the ground that, under present requirements, the declaration system is practically ineffective insofar as it relates to farmers.

A number have suggested that the present declaration system and payments of estimated tax be abolished in their entirety, while some propose that if the system is continued it be retained solely on a voluntary basis. There is some indication that criticism of the system has increased recently as the result of a stricter enforcement of these provisions by the Bureau within the last 2 years. In lieu of the present declaration system, one individual suggested the use of tax stamps which could accomplish the same general purpose. Under this suggestion, these stamps, in denominations ranging from $1 to $100, would be purchased by taxpayers who are now required to pay estimated tax. Such purchases could be made at any time during the year at the convenience of the taxpayer and the stamps subsequently transmitted with the final return as evidence of the prior payment of tax.

However, instead of abolishing the present system completely, a number of persons have submitted suggestions intended to modify the present requirements. It is frequently pointed out that under the present filing requirements hundreds of thousands of taxpayers are required to file a declaration of estimated tax although they will, in fact, owe no tax. Some have suggested that a declaration not be required where there is no estimated tax due. Another has suggested that if 75 percent of an individual's income is subject to withholding, no declaration should be required. It has also been argued that individuals receiving salaries, wages, or commissions subject to withholding should not be required to file a declaration if their other income not subject to withholding does not exceed $1,000. Furthermore, it has been pointed out that the filing requirements, as they relate to wage earners, do not make an appropriate allowance for the standard deduction, although they do take into account the taxpayer's personal exemptions, and it has been suggested that this deficiency be corrected.

A number of suggestions for liberalization of the present declaration system have been received with respect to taxpayers with business income. Some have suggested that business or professional persons be exempt entirely from filing declarations, or, as previously pointed out, be treated in the same manner as are farmers under present law. The latter suggestion is supported on the ground that, like farm income, business income is frequently seasonal or unpredictable. It has also been pointed out that such uncertainty is particularly acute with respect to new businesses, and as a result it has been suggested that any taxpayer who enters a new business or profession be relieved of filing a declaration for the first 2 years. Some of those who suggest complete

elimination of declaration requirements for taxpayers in business point out that corporations have no equivalent requirement and suggest that unincorporated businesses should be extended similar treatment.

Businessmen have also pointed out that the present gross income test for filing a declaration results in much unnecessary filing because even where the gross income test is met, a business may have a net loss for the year. Another criticism of the gross-income test points out that a taxpayer who, for example, has $800 of long-term capital gains has to file a declaration because the entire gain is included in gross income. However, only 50 percent of that gain is includible in adjusted gross income and, therefore, will not be taxable in the absence of other income. Moreover, the gross income test does not take into account the taxpayer's personal exemptions or his standard deduction, and this is another source of present criticism.

A number have referred to the difficulty of making accurate estimates within the requirements of present law. One suggestion in this regard is that the declaration be based on actual income earned in the quarter and not on forecasted annual income as at present. However a number of others have approached this problem by recommending that all penalties relating to the declaration and payment of estimated tax be abolished. In a more limited area, it has been suggested that the penalty for an underestimate on January 15 should be removed. One correspondent, in support of a proposal to remove all penalties with respect to underestimation, argues that the present penalties are of necessity so arbitrary as to amount to confiscation rather than a legal exercise of the taxing power, and, thus, are in violation of the fifth amendment of the Constitution. Another has stated that the present system of the penalty for underestimation appears to be largely a matter of administrative discretion, and it was suggested that this provision could be more equitably administered if the penalty were made self-assessing on the face of the return.

One individual suggests that taxpayers receive interest on payments of estimated tax.

One correspondent pointed out that while a taxpayer traveling abroad is given until June 15 to file his final income-tax return, he is still required to file his declaration of estimated tax on March 15, and it was suggested that the latter date be moved up to coincide with the final return date.

2. Withholding of tax (secs. 1621 through 1627)

Under the present law, the withholding system (except in the case of nonresident aliens and corporations) applies only to wages and salaries and the withholding rate is geared to the first bracket normal and surtax rate. There is also a provision which allows an employer to withhold as much tax as his employee requests, although this must be by mutual agreement. Some have suggested that the present 30-percent withholding in case of nonresident aliens and foreign corporations be increased to 55 percent to accord more closely with present tax rates, but one taxpayer recommended that such withholding be eliminated in the case of film rentals paid to foreign films. It was also suggested that actors be eliminated from their status of independent contractors so as to insure the Government of collecting taxes by withholding. It was suggested, too, that where a taxpayer is an employee but is also

conducting a private business in which he is losing money that he be permitted to file for a quick refund of the amount withheld from his salary.

One correspondent suggested that wage earners be permitted to use up their exemptions before withholding begins, presumably in order to minimize the number of refunds. Another taxpayer with a similar objective suggested that the withholding rate be geared to collect only 80 percent of the tax. The suggestion has also been made that in the interest of simplicity and to more closely withhold the correct tax for possibly 70 to 80 percent of the taxpayers, the first surtax bracket be extended from $0 to $2,000 to $0 to $4,000 and the withholding rate be geared to the combined normal and surtax rate on this first $4,000 of taxable income. The suggestion has been made that in case of salaried employees, the amount shown on this withholding certificate be considered their tax liability and that no adjustment be made at the end of the year so as to eliminate the necessity of filing a final return.

It has also been suggested that withholding be eliminated in the case of dependents who do not earn as much as $600 a year. One employer suggests that employees be furnished form W–2 only after the close of the taxable year and not upon termination of their employment unless such form is specifically requested by the employee. Moreover, another correspondent urged that the present requirement that statements for employees whose employment has been terminated be filed within 30 days after such termination be changed so that such statements may be filed with regular quarterly statements 45 days after the end of the quarter. He also suggested that the filing date for information returns, forms 1099 and 1096, be extended to March 15. The suggestion has also been made that withholding agents be permitted to submit personal checks directly to the Director of Internal Revenue for the amount withheld instead of remitting through banks as required under the present system. It has been proposed that employers should be paid in the neighborhood of 3 percent of the amount withheld to compensate them for the expense of withholding. The suggestion has also been made that withholding should be eliminated on the ground that such an action would be the most effective way to make all wage earners tax-conscious. It is argued that, under the present system, the average employee only looks at his take-home pay.

A number of taxpayers have suggested that withholding be extended to such items as dividends, rents, capital gains on real property where the transfer is through a title company, and to the income of domestic servants.

One taxpayer suggested that withholding under the Federal Insurance Contribution Act and the Federal Unemployment Tax Act and withholding for income tax purposes should have greater uniformity of treatment than exists under present law. For example, wages in kind are generally subject to FICA tax but not always to income tax withholding, and this particular taxpayer believes that this situation is productive of administrative confusion.

It has been suggested that merchandise prizes awarded to employees should not be subject to withholding but that, as an alternative procedure, the employer simply be required to file an information return relating to such payments.

3. Filing of final returns (sec. 53)

The present law provides the following rule:

> (a) TIME FOR FILING.—
>
> (1) GENERAL RULE.—Returns made on the basis of the calendar year shall be made on or before the fifteenth day of March following the close of the calendar year, except that in the case of the return of the fiduciary of an estate or trust, the return shall be made on or before the fifteenth day of April following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the fifteenth day of the third month following the close of the fiscal year, except that in the case of the return of the fiduciary of an estate or trust, the return shall be made on or before the fifteenth day of the fourth month following the close of the fiscal year.

A very large number of the responses to the questionnaire suggested that the due date for filing a final return by calendar-year taxpayers be extended to April 15. Under present law, the great majority of all tax returns filed—those for calendar year taxpayers—must be prepared between January 1 and March 15. It is pointed out that many taxpayers who are in business have audits after the close of the year which must be completed before the tax return can be prepared, and it is maintained that taxpayers and their tax advisors have great difficulty in preparing complete returns within the present short period of time. In addition, it is argued that the Government itself is unable to cope with the flood of returns it receives during the month of March. As a result it has been frequently proposed that the due date for filing returns be changed to the 15th day of the 4th month following the close of the taxable year. At the same time it is suggested that the declaration of estimated tax now required on March 15 be moved to the April 15 date.

Fiduciary returns are due April 15 under present law but the trust beneficiaries are required to include the taxable income distributable from the fiduciary on their returns due March 15 and for that reason the fiduciaries are not aided by the extended time for filing since all the necessary information must be compiled in advance of March 15.

While some taxpayers feel that the present March 15 date allows plenty of time for the filing of the final return, others think March 31 or April 1 would be an appropriate date. One taxpayer suggested that in the case of calendar-year taxpayers the dates be staggered as follows: (1) Forms 1040A and 1040 representing wages, salaries, interest, rents, dividends, etc., be continued on the March 15 basis; (2) All forms 1040 consisting of business partnership or trust income be filed by March 31; (3) Forms 1041 for estates and trusts be continued at April 15; (4) Forms 1065 for partnerships be changed to March 31; (5) Forms 1120 for corporations having taxable income under $25,000 and not subject to the excess-profits tax be required by April 15; (6) Forms 1120 and schedules EP 1120 be extended to May 15; (7) The speedup in corporate-tax payments which will in 1955 require two payments in the first half of the year should be amended to make these two payments due on March 31 and June 30.

One taxpayer suggested that the filing requirements for individuals be spread throughout the entire year by dividing the alphabet into 12 groups; for example, those taxpayers whose last names begin with A, B, and C would file in January and the next group in February, etc. One taxpayer suggested that the filing date for filing returns of indi-

viduals be moved up to June 15. In recommending a later filing date, another taxpayer cited the filing requirements for individuals in Holland:

> This return must be filed before July 15 (pertaining to the preceding calendar year). If this date is too early for you, you must file the enclosed estimated tax return before July 15. If you do this you have an automatic deferment to file the regular tax return until October 15.

A similar suggestion was to the effect that a taxpayer who files a tentative return on time should be granted automatically an extension of 60 to 90 days for filing his completed return. It was also suggested that "enrolled agents" of the United States Treasury be permitted to file returns 5 days after the due date for their clients. A return filed in such a manner should be accompanied by an appropriate certificate that this late filing was done in lieu of a request for an extension of time. It has also been suggested that, while the due date itself should not be changed, local revenue officers should have greater authority for the granting of requests for extension submitted by accountants and attorneys in the case of corporate returns. In this same connection, it has been recommended that corporations be granted optional extensions up to a maximum of two months.

To promote the early filing of returns, the proposal has been made that a schedule of discounts for early filing should be enacted. The discount, for example, might be 4 percent if the return is filed in the first permissible month, 3 percent in the next permissible month, 2 percent in the third permissible month, and no discount if filed in the month in which the return is due. Tied in with this proposal is the suggestion that the Bureau should be allowed 2 months following the month the tax return is filed to process and make refunds, with no interest accumulating. This procedure, it is said, would cause an even flow of returns and would permit adequate time for the Bureau to examine refund returns, thus eliminating thousands of small refunds that postaudit reveals should not have been made.

Several taxpayers have evidenced interest in proposals to eliminate entirely the necessity of filing final returns for large numbers of individual taxpayers. For example, it has been suggested that a taxpayer, all of whose income is subject to withholding, not be required to file a return when his status has not changed during the taxable year. Several have recommended that the $600 gross income filing requirement be changed to an amount equal to the amount of the exemptions claimed by the taxpayer. For example, a married couple without dependents would not be required to file unless its gross income exceeded $1,200 and, if they had one dependent, the filing test would be $1,800. It is pointed out that such taxpayers are not taxable, and the belief has been expressed that they make up the bulk of the approximately 15 million returns filed today with no tax due. It is argued that the filing of such nontaxable returns simply represents useless paperwork for the Bureau of Internal Revenue.

A number of miscellaneous suggestions have also been received which relate to the filing of returns. For example, it has been suggested that the supplement T tax table be extended from the present $5,000 adjusted gross income maximum to cover $10,000 of such income. Under present law, married taxpayers who file separate returns may change their election so as to file a joint return. However, it is

not permissible to file separate returns after filing a joint return, and it has been suggested that a change of election be likewise permitted in the latter case.

Another correspondent suggested that, in the interest of simplicity, the withholding statement (form W-2), the withholding exemption certificate (form W-4), and the optional tax return (form 1040A) be combined.

On the question of small deficiencies that are not paid following notice and demand, it has been proposed that where the deficiency does not exceed $25, no attempt at enforcement should be made but that the amount of the deficiency should be carried over to the following year either to be offset against any refund due or added to any further deficiency, and collection would then be undertaken on the combined amount.

4. Accelerated corporate payments (sec. 56 (b))

Under present law, calendar-year corporations in paying 1952 tax liabilities will make two payments of 40 percent each within 6 months after the close of the taxable year and 2 payments of 10 percent each during the next 6 months. For 1953 liabilities, corporations will make two payments of 45 percent each and 2 payments of 5 percent each, and with 1954 liabilities, will reach the permanent arrangement of two payments of 50 percent each within 6 months after the close of the taxable year.

Many of the replies to the questionnaire indicated that corporations are experiencing difficulties under this plan, particularly in the case of small or new corporations. It is proposed that the law return to the old scheme of 4 equal quarterly payments.

Another suggestion would provide for 3 or 4 installments instead of the 2 installments provided in present law for 1955 and subsequent years. Another plan would require payment of 80 to 90 percent of the liability in installments made within the first half of the year, thus maintaining on a permanent basis either the 1953 or 1954 payment schedule. It has also been suggested that corporations be permitted to file a tentative return with the first installment and a final return with the last installment.

H. SUPPLEMENTAL PROVISIONS

1. Exemptions from corporate tax (sec. 101)

The code enumerates the types of organizations which are exempt from taxation as corporations. In general, such corporations, associations, clubs, etc., are exempt if not organized for profit and if no part of the earnings inures to the benefit of any private shareholder or individual. The Revenue Act of 1950 provided for taxation of the unrelated business income of certain of the above types of corporations which were otherwise exempt from tax. (See supplement U of the code.)

The suggestions received in connection with exempt organizations in general express the belief that the exemption operates unfairly if the exempt organization is in competition with private business. Several correspondents indicate that the tax imposed on the unrelated business income of certain exempt organizations is not sufficiently

stringent. Some would increase the tax imposed. Others would broaden the scope of supplement U. In the opinion of some, the use of the sale and leaseback device by charitable and educational organizations has not been sufficiently deterred by the supplement U provisions. One letter proposed an income tax on the unrelated business income of churches. On the other hand, some correspondents have stated that the present exemption for churches from the tax on unrelated business income is being limited by the Bureau in its rulings. These correspondents indicate that the Bureau has ruled that separate nonprofit corporations such as foreign missions, home missions, etc., do not come within the exemption from the unrelated business income tax even though these agencies are wholly owned and controlled by a church. It has, therefore, been proposed that the exemption given to churches should be extended to any board or agency of a church or to any convention or association of churches.

A special problem involving cemetery lots was mentioned by one correspondent. Certain cemeteries operated for profit nevertheless have perpetual-care trusts into which the proceeds from the sale of lots must be irrevocably placed. No part of such proceeds can inure to the benefit of any private shareholder. It is suggested that the income of such a perpetual-care fund should be exempt from taxation and that contributions thereto should qualify as charitable deductions.

A problem related to the exemption of certain organizations from taxation is the question of special taxation provisions for certain types of enterprises, such as mutual-savings banks, building and loan associations, and life-insurance companies. Several letters have suggested that mutual-savings banks and building and loan associations should be placed on a parity with commercial banks so that the tax burdens of each would be comparable. Others indicated a belief that life-insurance companies are not paying their fair share of the Federal tax burden.

Another somewhat related problem is the tax exemption enjoyed by municipally owned utilities. Several suggestions have been received that the proprietary functions of local municipalities, especially in the utility field, should be subject to Federal income tax. Others have suggested that the income from any securities issued in the future for the purpose of financing public proprietary enterprises should be subject to tax.

2. Improper accumulation of surplus (*sec. 102*)

Section 102 of the Code imposes, in addition to the usual income taxes, a surtax upon the net income of a corporation if the corporation—

> is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders * * * through the medium of permitting earnings or profits to accumulate instead of being divided or distributed * * *.

Income taxes paid, dividends distributed, and certain other items are deductible in arriving at the net income upon which the special surtax is imposed.

A relatively large proportion of the responses to the staff inquiry directed at least some criticism at section 102. A number of correspondents believe that the provision should be eliminated in its entirety. They state that the cases of intentional accumulation for

the purpose of avoiding taxes on shareholders are relatively few and, therefore, that the need for such a provision is far outweighed by the restrictive influence it exerts on the normal growth of corporate business. On the other hand, a number of replies recognize that such a provision is needed so long as double taxation of dividends remains a fixture of the income-tax structure.

However, even those who recognize the necessity of the principle inherent in section 102 join in the criticism of the practical effect of the present provision. A recurring comment is that the section substitutes the business judgment of a revenue agent for that of a corporation's own management. Small businesses state that they are prevented from retaining sufficient earnings to create a reserve against possible future loss periods. They stress the importance of supplying such a "cushion" out of accumulated earnings in view of their relatively poor credit position. Likewise, they state that they must largely rely on accumulated earnings to finance expansion. Depreciation allowances which are inadequate in view of present high replacement costs are listed as another reason for the retention of a relatively high proportion of earnings. In general, small businesses stress the importance of retained earnings because of limited ability to borrow and because of limited access to new equity capital. In this connection, some state that section 102 favors large, publicly held corporations, which are less dependent on retained earnings, and, as a result, encourages the absorption of small business by big business.

While several correspondents recognize that the courts, in applying section 102, have been liberal in determining what constitutes a reasonable accumulation of surplus, they feel that the section as it now stands represents a constant threat which leads many boards of directors, perhaps without real reason, to distribute a larger proportion of earnings than sound business judgment would dictate. It is suggested that this anxiety arises from two major sources: first, section 102 creates uncertainty because it contains no fixed rule or yardstick for the guidance of management; and, secondly, once it is claimed that the corporation has accumulated earnings beyond its reasonable needs, the section places the burden on the taxpayer of proving "by the clear preponderance of the evidence" that such accumulation is not for the purpose of avoiding shareholders' taxes.

A number of suggestions have been received to the effect that definite measurement rules should be written into section 102, although some writers believe such a yardstick would not be feasible in view of the diverse situations of different taxpayers. Some taxpayers would favor a provision which would permit a corporation to retain at least some fixed percentage of earnings (e. g., 50 percent, 40 percent) after taxes without application of section 102. One taxpayer suggests relating the amount of earnings which can be retained to sales volume. It has also been suggested that a corporation be permitted at least to conform to its dividend policy of prior years.

A number of correspondents consider the present burden-of-proof requirement as unfair, particularly in view of the fact that section 102 is a penalty provision. They would shift the burden to the Government, especially with respect to new corporations. Several alleged cases have been cited of revenue agents using the threat of section 102 in order to force the taxpayer's agreement to other items in

controversy, and it is felt that shifting of the burden of proof would serve to eliminate this practice.

As indicated above, most complaints with respect to section 102 come from relatively small business. The suggestion has been made, therefore, that small, new corporations be exempted entirely from the application of the section. A specific suggestion along this line was to make the section inapplicable to any corporation with assets of less than $800,000. Another would exempt corporations with capitalization of $500,000 or less until earned surplus reached twice that amount.

In practice, section 102 is directed at closely held corporations, although no such limitation is spelled out in the statute, and it has been suggested that the section be expressly confined to such situations. Presumably, the limitation would be in terms of some specified number of stockholders or in terms of some specified proportion of stock interest, irrespective of the number of shareholders, or both. For example, the section could be limited in its application (1) to corporations with 50 or less stockholders, and (2) to corporations, regardless of the number of shareholders, if any one shareholder (together with his family) beneficially owns 15 percent or more of the outstanding common stock. Suggestions of this type are along the line of writing into the statute the actual rules which the Bureau of Internal Revenue appears to employ as a guide in applying the section. It has also been suggested that such an approach might take the form of specifying certain factors to be considered in administering the provision. These might be: extent of earned surplus, unusual liquidity of assets, unusually high ratio of current assets to current liabilities, percentage of earned surplus retained, etc. It is pointed out that the inclusion of such factors in the statute proper might at least provide a guide for management and remove some of the present uncertainty as to the scope of the section.

Another specific limitation which it has been recommended be included in the statute would limit section 102 to cases where the surplus in question is held in cash or marketable securities unless such liquid assets are clearly needed to provide adequate working capital. Various tests have been suggested which pertain to the use a corporation makes of its retained earnings. As one correspondent states:

> For example, where a profitable corporation, instead of distributing its profits in the form of dividends, permits its stockholders to borrow the corporate funds, or where the corporate funds are, at the direction of the stockholders, invested in ventures entirely divorced from the corporate business, such arrangements should continue to be the target for attack under section 102.

Another correspondent, however, takes an opposite viewpoint. He recommends that section 102 should not be invoked if corporate funds are invested in a new or different enterprise provided 95 percent of the voting stock of the new enterprise is acquired.

There appears to be considerable uncertainty under the present law as to the effect of dividends declared and paid after the close of the corporation's taxable year. A number of correspondents suggest that dividends declared and paid within some specified period after the close of the year, say 60 or 90 days, should be taken into account in determining the extent of retained earnings during the prior year. It is pointed out that many companies close their books only once a year and are not in a position to determine their dividend policy until after

the end of the year. On the other hand, one writer suggests an express requirement that dividends be declared and paid during the taxable year in order to remove existing uncertainty. Another points out that permitting payment after the close of the year might lead corporations to postpone payment for the sole purpose of giving shareholders the advantage of a change in tax rates.

A number of taxpayers have suggested that the penalty tax be imposed only on that portion of the corporation's accumulation of surplus that is determined to be beyond the reasonable needs of the business.

Finally, several miscellaneous suggestions have been received with respect to section 102. These include recommendations to exempt banks, to reduce the amount of the existing penalty, and to permit taxpayers to avoid the penalty by payment of a deficiency dividend. (For a description of the deficiency dividend procedure see Personal holding companies, p. 101.)

3. Averaging taxable income (sec. 107)

The tax on compensation for personal services rendered by a partnership or individual may be computed as though the compensation had been received ratably over the period of such services prior to receipt of compensation, provided: (1) the services were rendered over a period of 36 months or more and (2) at least 80 percent of the compensation is received in a single taxable year.

Similarly, the gross income from an artistic work or invention may be taxed as though received ratably over a prior period of 36 months or less provided: (1) the work done to produce the item extended over a period of 36 months or more, (2) the gross income to be prorated is at least 80 percent of the total gross income therefrom up to and including the taxable year plus the gross income therefrom in the succeeding 12 months, and (3) the gross income to be prorated is not taxable as long-term capital gain.

It is also provided with respect to certain limited cases that the tax on back pay which would have been received in prior years but for certain circumstances may be computed as though the back pay had been received in the periods to which attributable provided the back pay exceeds 15 percent of gross income for the taxable year.

The present averaging provisions are said to be deficient in the following respects:

(1) The provisions for prorating compensation received for personal services fail to provide for lump-sum payments on continuing (as distinguished from completed) projects.

(2) The averaging provisions fail to provide for taxpayers with widely fluctuating income.

(3) The averaging provisions fail to provide for lump-sum receipt of investment income earned over a prior period, such as cumulative dividends on preferred stock and delinquent interest.

It has been proposed that the averaging provisions of the code should be amended to extend similar averaging treatment to cases where taxpayers performing continuing services receive in one year 80 percent or more of compensation for past services performed over a period of at least 36 months.

It has also been suggested that the averaging provisions be extended to lump-sum receipts of cumulative dividends, delinquent interest, and similar items.

Others have suggested that all taxpayers be allowed to average their income over a specified period of years. One specific proposal would be to provide a reduction in the individual's tax rate if his income for the taxable year exceeds the average of his income for the preceding 4 years. Another proposal is to permit cash-basis taxpayers to compute the tax on lump-sum receipts of earned income as though such income had been received in the years it was earned. This proposal would, in effect, remove the present 36-month limitation in the present statute.

4. Income from foreign sources (secs. 109, 116, 131)

(*a*) *Western Hemisphere trade corporations* (*sec. 109*).—Under the present law a domestic corporation must meet the following qualifications in order to claim the status of Western Hemisphere trade corporation:

(1) The entire business of the domestic corporation must be carried on within the geographical limits of North, Central, or South America, including the West Indies and Newfoundland; (2) 95 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) must have been derived from sources without the United States; and (3) 90 percent or more of its gross income for such period must have been derived from the active conduct of a trade or business.

A Western Hemisphere trade corporation is basically taxed as any other domestic corporation but is entitled to claim the following additional tax credits and allowances:

(1) Under the present provisions, there is allowed a credit for both normal tax and surtax purposes an amount equal to 27 percent of the normal tax income (for taxable years beginning after March 31, 1954, this credit is increased to 30 percent).

(2) A Western Hemisphere trade corporation is exempt from the excess-profits tax.

(3) The surtax net income of the Western Hemisphere trade corporation included in a consolidated return is not subject to the 2-percent tax increase for consolidation. However, the filing of such a consolidated return disallows the exemption to the corporation from the excess-profits tax.

Most of the suggestions that have been received dealing with the Western Hemisphere trade corporation provisions have either proposed various extensions of the provisions or have advocated certain clarifying amendments. For example, it has been suggested that all domestic corporations engaged in foreign trade should be granted the benefits of the Western Hemisphere trade corporation provisions (section 109). In effect, this proposal would enlarge the geographical scope of section 109. Some have recommended such an enlargement of the geographic scope but with limitations to exclude Iron Curtain and similar countries with which it would be deemed inadvisable to encourage trade. Along somewhat similar lines as the above is the proposal that a lower rate of income taxation should apply not only to corporations qualifying as Western Hemisphere trade corporations, but to the foreign income of any corporation having a foreign

permanent establishment or branch which on a separate accounting basis would meet the same test as a Western Hemisphere trade corporation.

Others have stated that the present Bureau rulings defining what is income from without the United States place undue emphasis on the legal technicality of passing of title. To qualify under the 95-percent limitation, it is said, unbusinesslike measures are taken to insure that the title to goods will be construed as having passed outside the United States. It is contended that no useful purpose is served by interposing the technical concepts of the law of sales and insurance into the taxation concept of Western Hemisphere commerce. It is urged that the basis of Western Hemisphere tax treatment and the determination of the source of the income should be the destination of the goods and the place of their first use without regard to who bears the risk of loss during shipment and where the goods may be when title passes. A somewhat related proposal is the suggestion that the present 95 percent of gross-income requirement should be changed to 95 percent of sales exported to foreign purchasers. Another suggests retention of present law but would add an alternative that the 95-percent test may be met if both buyer and seller certify that the goods have been shipped abroad for use outside the United States, with severe penalties imposed for false certification. Others have proposed more generally that definitions should be provided by statute as to what constitutes deriving income from sources outside the United States.

Some correspondents have indicated that the requirement of doing all business in the Western Hemisphere has been too narrowly construed. It has been suggested that incidental purchases outside the Western Hemisphere should not disqualify a corporation from receiving the benefits of the Western Hemisphere provisions.

Others have recommended that the complete surtax exemption previously granted Western Hemisphere trade corporations should be restored and the tax credit that is now allowed should be abolished, or, as an alternative, the credit should be increased to the same proportion of the present combined normal tax and surtax as the surtax was of the combined taxes when the surtax exemption was first allowed.

(*b*) *Foreign income and foreign tax credit* (*secs. 116 and 131*).—In general, foreign income, war-profits, and excess-profits taxes are allowed as either a credit against United States income tax or as a deduction in computing net income, at the option of the taxpayer. If the foreign-tax credit is elected, certain limitations apply.

These limitations are commonly denoted (1) the per country limitation and (2) the overall limitation. For an individual the foreign-tax credit may not exceed on a per country basis the proportion of his net income from the foreign country to his total net income. Similarly, on an overall basis the foreign-tax credit may not exceed the proportion of his net income from all foreign countries to his total net income. The same limitations are applicable for corporations except that the proportion is based upon normal tax net income instead of net income.

These limitations have been criticized by a number of taxpayers. It is stated that the "overall limitation" adversely affects taxpayers with operations in more than one country and operates so as to reduce the allowable credit in cases where a taxpayer earns profits in one

country but suffers a loss in another. On the other hand, the "per country limitation," it is said, operates to prevent total taxes paid in any given country from being offset against United States taxes whenever the foreign country rate is higher than the United States rate but the rate in another foreign country is lower than the United States rate. It has been proposed, therefore, that taxpayers be allowed to elect annually either the per country or overall limitation. Others have criticized the per country limitation on the ground that this limitation places an undue premium on the form in which business is conducted in foreign countries—that is, whether by one foreign subsidiary doing business in several countries or by separate foreign subsidiaries in each country. It is indicated that where only one foreign subsidiary is employed, for purposes of the foreign tax credit, all its business is deemed income derived from the country in which the foreign subsidiary is incorporated. The per country limitation has also been criticized as being a bar to the treatment of all foreign business as a unit, and the proposal made that the limitation be eliminated. Some correspondents would go even further, however, and eliminate both the per country and overall limitations.

A number of correspondents have suggested that the provisions under present law relating to foreign income give an unfair tax advantage to corporations conducting their foreign business through foreign subsidiaries as opposed to those conducting their foreign business through the use of branches or domestic subsidiaries. Corporations with foreign subsidiaries, it is argued, may accumulate undistributed profits free from United States income tax whereas domestic corporations operating through foreign branches are taxed upon their entire foreign income to the extent that the United States tax exceeds the foreign tax credit. It has therefore been proposed that deferment of reporting income from foreign branches or from foreign operations of domestic subsidiaries should be permitted until the income is remitted to the United States. One correspondent suggests as a modification of this proposal that no remitted income should be deemed taxable until the taxpayer has recovered the total of his foreign investment. It has also been suggested that dividends received from foreign subsidiaries be viewed as a return of capital, not taxable until the total of the foreign investment has been recovered, on the ground that exchange and other restrictions usually make it improbable that the investment will ever be recovered. On the other side of the picture, some correspondents have indicated that corporations operating through foreign subsidiaries do not have certain tax advantages possessed by corporations operating through foreign branches. It is stated that a domestic corporation operating through a foreign branch may offset any losses from its foreign operations against United States income whereas if the foreign operation is conducted through a foreign subsidiary such offsetting is not possible. It has therefore been proposed that domestic corporations with foreign subsidiaries should be given the same right to file and obtain the benefits of consolidated returns that is now granted to affiliated domestic corporations.

A more sweeping proposal that would cut across the foreign income field is the suggestion that all foreign income derived from permanent establishments outside the United States should be exempt from United States taxation. This proposal would eliminate the Western

Hemisphere trade corporation provisions as well as the foreign tax credit provisions. In support of this proposal, it is argued that taxation of income should be grounded on a concept of the source of the income rather than on a concept of the nationality of the income producer and that the country in which the income is produced should be the best judge of the appropriate level of taxation for such income. It is likewise argued that this proposal would encourage investment of United States capital in foreign countries, especially technically underdeveloped countries, since these usually impose relatively low taxes. A more restricted version of this proposal is the suggestion that no United States tax should be imposed upon any foreign income until the income is returned to the United States. This latter proposal is coupled with a proposal for an incentive system of tax-rate reduction on a country-by-country basis (similar to the general rate reduction now provided for Western Hemisphere trade corporations) with the rate reduction in each country dependent upon (1) the underdeveloped status of the country and the need to complement the point 4 program, (2) budgetary requirements for direct appropriations to the particular country, (3) other political and economic risks of investment.

Other correspondents have suggested that clarification is needed as to what foreign taxes may be deemed to be in lieu of income taxes for purposes of the foreign tax credit. Under present law the term "income, war-profits, and excess-profits taxes" for which a foreign tax credit may be allowed is defined to include foreign taxes imposed "in lieu of" such income, war-profits, and excess-profits taxes. The administrative interpretation of this statutory provision has been criticized as construing too narrowly the question of what foreign taxes are imposed in lieu of income taxes. It has been proposed that the definition of "in lieu of" taxes should be clarified by further legislation.

An extension of the foreign tax credit to noncorporate shareholders of foreign corporations has also been proposed. Under present law, where foreign income, war-profits, or excess-profits taxes are paid by a foreign corporation 10 percent of whose stock is owned by a domestic corporate taxpayer, the domestic corporation is deemed to have paid such proportion of the foreign taxes as its dividends received from the foreign corporation bear to the accumulated profits of the foreign corporation from which the dividends were paid. Some taxpayers have recommended that similar treatment should be extended to noncorporate shareholders. Others have proposed a more limited amendment. They would continue to restrict the credit to corporations but would extend it in the alternative to domestic corporations owning 10 percent of the stock of a foreign subsidiary or stock in such subsidiary in excess of a specified minimum amount, say $500,000.

Another technical complaint about the foreign tax credit deals with the statute of limitations. The present law allows the Commissioner to recompute the income tax where there has been a refund of foreign taxes and recover for the prior period any deficiencies. There is no statute of limitations. It has been suggested that in all fairness taxpayers should have the same privilege of recomputing their foreign tax credits for prior years in order to obtain refunds where the foreign

country collects a deficiency in its tax for a prior year. In other words, if the statute does not run on a deficiency, it should not run on a refund.

Another foreign tax credit proposal is the suggestion that provision should be made for a 1-year carryback and 5-year carryforward of foreign taxes not used as a credit in the taxable year because there is a loss from domestic operations in that year.

The provisions for exclusion of earned income by United States citizens domiciled abroad has also been the subject of a number of suggestions. Section 116 (a) provides, in the case of citizens who are bona fide residents of a foreign country or countries or who have been present in a foreign country or countries during at least 510 days within a period of 18 consecutive months, for the exclusion of—

> amounts received from sources without the United States * * * if such amounts constitute earned income * * * attributable to such period.

Many persons are employed by American companies to perform services for those companies abroad, under contracts which provide not only for the payment of current salaries during the periods of such service but for the payment of pensions or annuities with respect to such foreign service after the termination of such foreign employment and when the former employee is in this country. It is debatable whether it was the intent of Congress that pensions received by persons previously engaged in performing services abroad are "attributable" to the services performed during prior periods in foreign countries. A special ruling of the Bureau of Internal Revenue issued on May 14, 1952, holds that it was not the intent of Congress that pension payments with respect to foreign services received by a taxpayer residing in the United States should be excluded under section 116 (a). A correspondent suggests that the clear language of the statute requires that such pension payments be excluded from gross income, since they are certainly attributable to the periods of foreign service. Further, it is argued that the clear and unquestioned intent of Congress was to encourage foreign trade and the services of American citizens in foreign countries in accordance with such trade, and that this purpose would not be served if pensions attributable to foreign service were to be subject to tax. It is suggested that in view of the Bureau ruling legislative clarification nullifying this ruling is desirable. On the other hand, a suggestion has been made that all income and profits received by citizens or resident aliens be subject to income tax regardless of the source or whether the taxpayer is a bona fide resident of a foreign country or present in a foreign country a specified number of months, with credits for taxes paid to foreign countries without limitation and adjusted only for the difference in currency exchange.

5. *Corporate reorganizations* (*sec. 112*)

(*a*) *Sale of corporation's assets in connection with liquidation*

Under present law, if a corporation distributes all its assets to its stockholders in liquidation, and thereafter the stockholders (independently of the corporation) sell these assets, there is only one aggregate tax—that paid by the stockholders on the excess of the value of the assets at liquidation over the cost of their stock. But if the corporation sells the assets and distributes the proceeds to the stockholders in

liquidation, there are two taxes: one paid by the corporation and one by the stockholders on the excess of the proceeds (less the corporation tax) over the cost of their stock. And in some cases, even where there has been a distribution and a sale of the assets by the stockholders, both the corporation and the stockholders are taxed under the Supreme Court's decision in the *Court Holding Co.* case (324 U. S. 331), if it can be shown that the sale was negotiated by the corporation but carried out by the stockholders.

Many persons contend that in all cases where there is a complete liquidation of a corporation accompanied by a sale of the assets, only one tax, that on the stockholders, should be imposed, and that there is no logical reason why the tax consequences should depend on whether the assets are sold by the corporation or by the stockholders.

One taxpayer advances the following solution to the problems relating to the sale of corporate assets and liquidation: Where a corporation has been in business at least 5 years, such corporation should be able to dispose of all its assets without taxable gain and the distribution to the stockholders should be taxable to them as a capital gain. In the case of the dissolution of a corporation not in business 5 years, any gain realized by the stockholders should be taxed as ordinary income and there should be no tax to the corporation as such.

Another suggests the following scheme: In the case of the sale of stock or the liquidation of a corporation, a tax 30 percent higher than the capital-gains tax should be applied with the tax being paid by the stockholders individually on the excess of the sales price or fair market value over the original cost, with no tax on the corporation.

Where a corporation wishes to acquire the assets of another corporation it is sometimes more practicable for the corporation to buy the stock of the other corporation and then liquidate it, the assets thus being acquired by the purchasing corporation. Where it is clear that the transaction was essentially the acquisition of assets for a specific purchase price in cash or the equivalent, the courts have held that the basis of the assets in the hands of the purchasing corporation is the amount paid for the stock (*Koppers Coal Co.*, 6 T. C. 1209; *Kimbell-Diamond Milling Co.* v. *Comm.*, 14 T. C. 74, affd. 187 F. (2d) 718). However, the purchaser of the stock thereby becomes a parent owning all the stock of a subsidiary corporation, and sections 112 (b) (6) and 113 (a) (15) provide that where there is a liquidation of a subsidiary corporation properties received by the parent have the same basis they had in the hands of the predecessor corporation, which might be much less than the amount paid (for stock) to obtain them. It is suggested that the law be clarified to make clear that sections 112 (b) (6) and 113 (a) (15) do not apply where a corporation buys stock to obtain the assets of the corporation, but that the basis of the assets so acquired shall be the cost of the stock. It has also been stated with respect to section 112 (b) (6) that, where the liquidation follows closely upon the acquisition of the stock, there is a question whether the section applies and whether the assets take a new basis measured by the cost of the stock. As a result, it has been suggested that the statute should permit taxpayers to elect to treat section 112 (b) (6) as inapplicable if the liquidation occurs within 1 year after the stock of the subsidiary was acquired; otherwise the section should apply. It is maintained that in this way the uncertainty would be eliminated.

One correspondent suggests that the principles of the preceding paragraph be applied where a corporation acquires the stock of another corporation to acquire a principal asset, say timberlands or mines or mineral deposits, owned by that corporation, and then causes the desired asset to be distributed to it in partial liquidation.

Another correspondent would prefer to enforce the present rule of sections 112 (b) (6) and 113 (a) (15): that no gain or loss is recognized when a corporation liquidates its subsidiary and that the basis of the assets to the subsidiary carry over to the parent after liquidation. He argues that the courts have exceeded their authority in carving out an exception to the statutory rule where a corporation's stock is purchased for the purpose of acquiring its assets. (See *Kimbell-Diamond Milling Co., supra.*) He suggests that an amendment to section 112 (b) (6) is necessary to make clear that its provisions are applicable even though the parent corporation is liquidating a subsidiary whose stock is purchased solely for the purpose of acquiring the subsidiary's assets.

(*b*) *Reorganization definition* (*sec. 112* (*g*))

The present statutory definition of "corporate reorganizations" (section 112 (g)) includes—

> the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation * * *.

This definition has been interpreted by the Supreme Court to exclude the acquisition by a subsidiary corporation of another corporation's assets in exchange for stock of the subsidiary's parent. Similarly, where the parent acquires substantially all the assets of another corporation in exchange for its stock but immediately thereafter transfers such assets to a subsidiary, the benefits of the reorganization provisions are denied (*Groman* v. *Commissioner*, 302 U. S. 82; *Helvering* v. *Bashford*, 302 U. S. 454; *Anheuser Busch, Inc.* v. *Helvering*, 115 F. (2d) 662, cert. den. 312 U. S. 699).

It is indicated that business reasons frequently dictate the use of a subsidiary corporation when assets are acquired in exchange for stock, and that no valid reason exists for withholding the benefits of the reorganization provisions in such a situation. It has been recommended, therefore, that such transactions should properly fall within the scope of tax-free reorganizations and that the definition of "reorganizations" should be amended to so provide.

One taxpayer suggests that the reorganization definition should be amended to make it clear that a tax-free reorganization occurs whenever the business interests and the proportionate interests of the shareholders remain unchanged even though there has been a change in the identity, form, or place of organization of the businesses so reorganized.

(*c*) *Permanent enactment of section 112* (*b*) (*7*)

Temporary legislation provided in recent revenue acts that stockholders who so elected could postpone recognition of gain in certain corporate liquidations completed in 1951 and 1952. (Similar temporary legislation was effective for certain liquidations occurring in 1944 and 1938.) In general, this temporary legislation was intended to facilitate the liquidation of domestic holding companies by permitting distribution of assets without capital gains tax to the share-

holders on the appreciated value of the assets. Assenting stockholders were taxed only upon their respective shares of accumulated earnings and profits as dividends and upon the balance of their gain at capital-gain rates only to the extent that the gain did not exceed the money or the value of after-acquired securities (securities acquired after August 15, 1950) distributed to them, if any. The remaining gain was not taxed. Instead the assets distributed took the basis of the stock exchanged therefor, decreased by any money received and increased by any gain recognized. In effect, the section permitted the distribution of assets which had appreciated in value without recognition of the gain to the stockholders resulting from such appreciation.

It has been stated that the time limitations on filing elections to qualify under section 112 (b) (7) did not afford sufficient opportunity for shareholders to inform themselves about the liquidation plan. It is recommended that section 112 (b) (7) be permanently enacted.

A proposal somewhat broader in scope than section 112 (b) (7) but along analogous lines is the suggestion that stockholders should be permitted to receive tax-free any securities held by a corporation for more than 10 years, the securities so distributed taking an allocable portion of the basis of the shareholder's stock in the distributing corporation.

(d) Liquidation in kind with continuation of the business

It is suggested that where a corporation is liquidated by the distribution of its assets to the stockholders who then retain the assets and continue the business as a partnership, gain or loss should not be recognized (as it is not recognized where a partnership is converted into a corporation). While section 112 (b) (7) has afforded relief in some such situations, it does not eliminate substantial taxes in other cases. It is suggested that, since the stockholder partners own directly what they previously owned indirectly, there has been no realization of income such as to justify the present tax.

(e) Capital loss on liquidation of subsidiary (sec. 112 (b) (6))

One taxpayer suggests that section 112 (b) (6) should be amended to permit a parent company to take a capital loss and apply such loss against other capital gains. The present law which specifies that no loss (or gain) shall be recognized on a dissolution of a wholly owned subsidiary corporation is deemed unfair where the subsidiary's principal assets consist of cash.

(f) Scrip issued in reorganization (sec. 112 (g))

Section 112 (g) provides that certain transactions will be deemed reorganizations if voting stock is received in exchange for properties. It is frequently necessary to issue scrip redeemable for cash instead of issuing fractional shares of stock. The amount of such scrip is usually not significant in relation to the whole stock issue involved, and the holders of various fractional interests represented by scrip can combine these fractions in exchange for full shares of stock. It is conceded that the Bureau of Internal Revenue has in numerous rulings held that the issuance of scrip in conjunction with a reorganization may be deemed the equivalent of the issuance of stock, but it is suggested that in view of a possible strict construction of section 112 (g) by the courts, or the difficulty and cost of obtaining Bureau rulings where small corporations are involved, the statute should be amended to state explicitly that scrip shall be deemed the equivalent of stock in such cases.

(g) Rights of successor corporations in corporate reorganizations

A successor corporation in a tax-free reorganization generally takes the same basis for the assets acquired that its predecessor had. But, in other respects, the successor is frequently not permitted to step into the "tax shoes" of its predecessor.

It is urged that a successor corporation in a tax-free reorganization should acquire all the benefits, privileges, and elective rights of its predecessor. With the possible exception of a merger involving no termination of the corporate entity, the successor corporation is generally denied the following benefits available to its predecessor:

Unused excess-profits credit and net operating loss carryovers and carrybacks, the deficit of the predecessor as an element of earnings and profits, involuntary liquidation and replacement of LIFO inventories, the tax-benefit rule, deficiency interest deductions, postreorganization expenses attributable to the predecessor, pension trust contribution and capital loss carryovers, amortization of emergency facilities, bond premium amortization, installment sales reporting, completed contract reporting, war loss treatment, intangible drilling expense elections, and so forth.

Some taxpayers have suggested a more restricted approach. They would grant a successor corporation the rights of its predecessor for a particular purpose, e. g., net operating loss carryover, but would apply certain qualifications to prevent tax avoidance.

(h) Extension of section 112 (b) (3) to Treasury refinancing

One taxpayer writes of difficulty with a Bureau ruling on refunding of Treasury bonds. The taxpayer indicates he was induced to exchange certain marketable Treasury bonds for other Treasury bonds with higher interest rate and more distant maturity partly upon the implied representation that the unamortized premium on the old bonds could be added to the par value of the new bonds and written off against the interest income of the new bonds over their life. The Bureau, however, subsequently ruled that the refunding operation by the United States did not qualify under the reorganization provisions as a nontaxable reorganization and hence any loss on the exchange suffered by holders of the old bonds would be recognized as a capital loss. The taxpayer suggests that the provisions of section 112 (b) (3) which provides for the nonrecognition of gain or loss on the exchange of corporate bonds in reorganizations (recapitalizations) should be extended to include refinancing or refunding by the United States or by State and local governments.

6. Involuntary conversions (sec. 112 (f))

Where property is compulsorily or involuntarily converted (as a result of destruction, theft, requisition, or condemnation) into similar property or into money which is reinvested in similar property no gain on the involuntary conversion is recognized. To the extent that proceeds from the conversion are not reinvested, gain is taken into account. The new property takes the basis of the property converted with adjustments for any funds received and not expended and for any gain taken into account. Prior to changes enacted in 1952, the involuntary-conversion provisions were applicable only to reinvestment of the proceeds subsequent to the date

of conversion. Anticipatory replacements were not covered. Also it was necessary to trace the proceeds of the converted property into the replacement property. The 1952 changes provided that the old rule would still obtain for conversions occuring prior to 1951, but that for 1951 and subsequent years anticipatory replacements would not bar relief and that tracing of proceeds would not be required. It has been recommended that the 1952 changes made in the involuntary-conversion provisions should be retroactively extended to conversions occurring in years prior to 1951.

It has been recommended that the present involuntary conversion provisions should be extended to involuntary sales or exchanges pursuant to court order or compromise agreements in antitrust proceedings or similar judicial or administrative orders under regulatory statutes. Provision is made in separate subsections for sales or exchanges in compliance with orders of the Securities and Exchange Commission and the Federal Communications Commission (sec. 112 (b) (8) and supplement R; sec. 112 (m)), but the scope of these provisions is not deemed sufficiently inclusive.

7. Gain from sale or exchange of residence (sec. 112 (n))

The Revenue Act of 1951 eliminated the capital-gains tax on the sale of a taxpayer's principal residence provided the proceeds are used to acquire a new residence. The basis of the new residence is adjusted in the amount of the gain not recognized on sale of the old residence. To qualify under this provision (sec. 112 (n)), the taxpayer (except for members of the Armed Forces) must purchase the new residence within 1 year of the sale of the old residence or must begin construction within one year of sale and complete such construction not later than 18 months after the sale.

Several taxpayers have suggested that the present period of 1 year for purchase of a new residence should be extended. Others have suggested that the provisions of section 112 (n) should be made applicable retroactively to years prior to 1951. Still others have recommended that section 112 (n) be replaced by a simpler provision providing that no capital gain should be realized on the sale of a residence.

Another problem involved in the sale of a residence involves the cost of papering, painting, and otherwise "fixing up" a residence prior to sale. These expenditures, it is stated, are properly expenses of sale. It is indicated, however, that a recent Bureau ruling holding that such expenditures are not capital expenditures has led Bureau agents to disallow the expenditures altogether in computing gain. It is recommended that it should be made clear, by statute if necessary, that these expenditures are expenses of sale which should properly be taken into account in computing gain.

One taxpayer suggests that the taxation of proceeds from the sale of a residence where the proceeds are not reinvested within the required 1 year has caused confusion and needs clarification. Another taxpayer recommends that section 112 (n) should not apply to the involuntary conversion of a farm residence. When section 112 (n) was enacted its provisions were regarded as more favorable to the taxpayer than the involuntary conversion provisions of section 112 (f) which required tracing of proceeds from the conversion and precluded an anticipatory

replacement. Subsequently section 112 (f) was amended to eliminate the tracing requirement and to permit anticipatory replacement. Under section 112 (f) the Bureau may extend the time for replacement in a proper case beyond the statutory period of 1 year. No such discretion is given, however, in section 112 (n). It is consequently recommended either that section 112 (n) should not apply to the involuntary conversion of farm residences or that section 112 (n) should be amended to give the Commissioner discretion to extend the 1 year and 18 months provisions in proper cases.

Under present law, where a farmer sells his farm, including his residence, and reinvests the proceeds in a new farm, only that portion of the transaction which relates to the farm house proper qualifies for the nonrecognition gain provisions of section 112 (n). It has been suggested that the section be extended to cover the gain from the farm itself if reinvested in a new farm. Similar suggestions have been received with respect to productive business property generally.

8. Exchange in kind (sec. 112 (b) (1))

Under present law no gain or loss is recognized where a property used in the trade or business is exchanged for like property for similar use. It is stated that, while such nonrecognition of gain or loss is desirable in the case of such properties as buildings or major items of equipment, the rule produces unnecessary accounting and other complications where it is applied to small items such as typewriters and other office equipment, automobiles, and so forth. For example, a typewriter with a tax basis (cost less depreciation) of $40 is traded in, with a cash payment of $110, for a new typewriter of the value of $170, the value assigned to the old typewriter thus being $60, not $40. Because the gain of $20 is not recognized, the basis of the new typewriter becomes $150, not $170. By successive trade-ins the tax basis of the third or fourth typewriter may become far different from its true value. It is suggested that, with respect to personal properties within some maximum value, each taxpayer have the right to elect to either recognize and report gains or losses on trade-ins, or to follow the present rule.

9. Mortgage foreclosures

Where a mortgagee acquires the mortgaged property at a foreclosure sale, the transaction is treated as a sale or exchange with gain or loss recognized. Treasury regulations provide that the gain or loss so recognized is the difference between the fair market value of the property at the date of foreclosure and the basis of that portion of the debt which is applied in satisfaction of the mortgagee's bid. To the extent that the indebtedness is not satisfied by the mortgagee's bid, a bad-debt deduction is allowed provided the debt is otherwise uncollectible from the mortgagor. The bad-debt deduction may be either a business bad debt deductible in full or a nonbusiness debt subject to the capital-loss limitations. If the mortgagee's bid price exceeds the principal due on the mortgage debt, the excess may be deemed interest income.

It has been suggested that the recognition of gain or loss in mortgage foreclosures should not depend upon the accident of the bid price which may be an artificial valuation because of the absence of competing bidders. Instead it is recommended that the fair market value of the property at time of foreclosure should be treated as a payment

on account of the debt with the deductibility of the balance of the debt to be determined under the usual rules applicable to debts worthless in whole or in part.

It is also indicated that trusts and estates face a special problem in mortgage foreclosures since foreclosures may not be deemed closed transactions for trust accounting purposes under local law. The respective interests of income beneficiaries and remaindermen are ordinarily determined when disposition is made of the foreclosed property. It is therefore recommended that where estates and trusts acquire mortgaged property through foreclosure, no gain or loss should be recognized and no bad-debt deduction should be allowed. The property acquired should take the adjusted basis of the debt immediately prior to foreclosure with appropriate adjustments for expenses incurred in connection with the foreclosure.

10. Adjusted basis for determining gain or loss (sec. 113)

In general, the basis of property is cost. Twenty-three statutory exceptions qualify the general rule in particular types of acquisitions such as acquisitions by gift, by inheritance, transfers in certain corporate reorganizations, and similar transactions.

A statutory basis provision which has been the subject of widespread taxpayer complaint is section 113 (a) (5)—basis of property transmitted at death. The general rule is that the basis of such property is its fair market value at the date of the decedent's death (or optional valuation date if the executor so elects). It has been suggested by a number of correspondents that the provisions of section 113 (a) (5) should be extended to all property which is includible in the decedent's estate. Under present law, certain property may be included in the decedent's estate for estate-tax purposes at its fair market value at decedent's death, yet for income-tax purposes the property may retain in the hands of the donee the cost basis of the decedent-donor. Such is the present rule for transfers held to have been made in contemplation of death and for property held in joint tenancy for which the decedent furnished the consideration. Such is also the rule for property transferred by a decedent to a trust in which the powers to alter and amend, but not the power to revoke, have been retained. The problem has been described as particularly acute in the case of a widow who finds such jointly held property, often a home, subject to capital gains tax when she is compelled to sell the property to pay the estate tax, the property being valued for estate-tax purposes at its full market value at the date of the husband's death. As a solution it has been proposed that property owned in joint tenancy or property transferred by the decedent inter vivos which has not been disposed of by the transferee should have the basis of fair market value at date of the decedent's death to the extent it is includible in the decedent's gross estate.

Another problem is the statutory provision for basis of property acquired by gift. Generally speaking, property transferred by gift retains the basis that it had in the hands of the donor except that for the purposes of determining loss the basis is the lesser of the fair market value at the date of gift or the donor's basis. It is suggested that the basis provisions for property acquired by gift should be amended to provide that the basis of the property in the

hands of the donee should be the value at which the property was taxed for gift-tax purposes—the fair market value at the date of the gift.

Another problem that has been presented dealing with the basis provisions concerns the adjustment of basis for carrying charges previously deducted as expenses. Since 1932, section 113 (b) (1) (A) has provided for the addition to the original basis of property of "taxes and other carrying charges" on properties, but no such additions can be made if deductions for such taxes and carrying charges "have been taken by the taxpayer in determining net income for the taxable year or prior taxable years." A correspondent cites a case where taxes and carrying charges with respect to timberlands have been deducted in the returns for many years but no tax benefit was derived from such deductions since there was little or no income from the tract during those years. It is suggested that such a case is analogous to that of the *Virginian Hotel* case (319 U. S. 523), where excessive depreciation deductions were made in returns for years when such deductions did not reduce the income-tax liability. Inasmuch as Public Law 539, 82d Congress, amended section 113 (b) (1) to correct this situation in the case of excessive depreciation, it is suggested that a similar amendment be made to provide for the addition to the original basis of property of amounts paid for taxes and carrying charges which, though deducted in prior years, produced no tax benefits.

11. Corporate distributions (sec. 115)

Dividends are defined in section 115 as any distribution by a corporation to its shareholders which is made from current earnings or profits or from earnings or profits accumulated since 1913. Distributions are deemed to be made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

One taxpayer has suggested that present law is deficient in the following respects:

(1) The statute contains no definition of the phrase "earnings or profits."

(2) The date when corporate dividends reduce earnings or profits has not been clarified.

(3) The judicially evolved rule that deficits may not be carried over to a successor corporation in a tax-free reorganization is unduly restrictive in situations where the reorganization is not motivated by tax-avoidance considerations.

It is therefore recommended that the corporate distribution provisions be amended to define "earnings or profits" as equivalent to taxable net income with adjustments for transactions which affect the actual amount available to the corporation as a source for dividends and to further provide that, for the purposes of determining earnings or profits, every distribution should be deemed distributed when actually or constructively paid. It is also recommended that the statute should permit a deficit to be carried over to a successor corporation in a tax-free reorganization if the reorganization had a valid business purpose.

Another area of the corporate distribution provisions that has been mentioned by a number of taxpayers is the taxation of stock dividends. Under present law, stock dividends are declared to be nontaxable to

shareholders to the extent they do not constitute income within the meaning of the sixteenth amendment to the Constitution. If the shareholder, however, has an election to receive either the stock dividend or money or other property, then the distribution is taxable to him regardless of the medium in which paid.

Whether stock dividends constitute income within the meaning of the sixteenth amendment has been a source of considerable litigation. In general, the test applied by the courts has been whether the proportionate interest of the shareholder is different after the dividend distribution than it was before the distribution. (Compare *Eisner* v. *Macomber*, 252 U. S. 189, with *Koshland* v. *Helvering*, 298 U. S. 441.) Where the shareholder's proportionate interest in the corporation is held not altered, the distribution of the stock dividend is deemed to merely give him the same economic interest in a different form so that he realizes no income therefrom.

In recent rulings and decisions the Treasury has taken the stand that the proportionate interest test applies not only to the dividend distribution as such but also to any concurrent provisions (prior agreement to sell the stock so distributed coupled with provision for its rapid redemption) that have the effect of changing the shareholder's proportionate interest.

It has been recommended that the tax-free character of a stock dividend should not be lost merely because the shareholder sells or intends to sell the stock so distributed or because the new stock is subject to a sinking-fund provision designed to secure its marketability.

Another correspondent points to a situation where dividends on presently outstanding preferred stock are in arrears and the corporation proposes to issue additional preferred stock in lieu of the unpaid dividends. The Supreme Court has held that such a distribution so changes the relative interests of the present holders of common and preferred stock as to constitute such a realization a receipt of taxable dividend income by the recipients of the new stock. A correspondent contends that the holder of a $100 share of preferred stock entitled to $50 of dividends from the surplus of the corporation has at that time a $150 interest in the assets of the corporation and that he has no greater nor different interest when as a substitute he holds a $100 share and a $50 share of preferred stock. He suggests legislation providing that no gain or loss results from the receipt of preferred stock by a present holder of preferred stock.

The question of partial liquidations which are treated as the payment of a dividend has been taken up by several correspondents. Section 115 (g) provides that if a distribution in partial liquidation of the stock of a corporation is made in such a way and under such circumstances as to indicate that it is actually equivalent to the distribution of a dividend, the amount received by the stockholders shall be taxed as a dividend. One correspondent presents a situation which involves the transfer by a corporation to its stockholders, in exchange for part of their stock holdings, of the real estate owned by the corporation, the stockholder partners thereafter operating the real estate as a continuing business. Since the distribution was pro rata to each stockholder in proportion to his stock and since at the time of the distribution the corporation had earnings and profits in excess of the value of the real estate, it was held by the Bureau that the transfer

of the real estate was the equivalent of the payment of an ordinary dividend. It is suggested that in such cases, where the recipients do not receive cash or the equivalent but merely properties which they continue to operate, the transaction be viewed as a partial liquidation and not as the receipt of a dividend.

There has long been a provision of the regulations under section 115 (g) that the sale by one stockholder of a corporation to the corporation of his entire stock interest is, as to that stockholder, a complete liquidation and that the provisions of section 115 (g) do not apply. One correspondent states that the Bureau of Internal Revenue has held that where the remaining stockholders are members of the family of the individual who sells all his stock to the corporation, such a liquidation may be viewed as the equivalent of a dividend under section 115 (g). The correspondent believes that the regulations should be adhered to whether or not the remaining stockholders are members of the retiring stockholder's family.

Another correspondent contends that section 115 (g) should be repealed. His contention is that since the stockholder has paid a capital sum for each share of his stock, if he thereafter receives back such capital sums for some of the shares, he has merely recovered his original capital and that no income subject to tax has thereby been received.

The provisions for redemption of stock to pay death taxes has concerned a number of taxpayers. Under present law if a corporation redeems its stock in such a manner as to make the redemption essentially equivalent to the distribution of a taxable dividend, the amounts distributed in redemption are treated as a taxable dividend instead of as a return of capital. An exception to this provision (sec. 115 (g) (3)) was enacted in the Revenue Act of 1950. This exception provides that dividend treatment will not apply where the redemptions are of stock included in a decedent's gross estate, to the extent the redemption distributions do not exceed death taxes imposed because of the decedent's death. The stock so redeemed must comprise more than 35 percent of the value of the decedent's gross estate. Also, the exception applies only to amounts distributed after the death of the decedent and within the 3-year limitations period for assessment of the estate tax or 90 days thereafter.

It has been stated that the above exception for redemptions to pay death taxes does not take into account the following problems:

(1) A correlation problem exists between the above provision (sec. 115 (g) (3)) and the penalty tax on improper accumulations of surplus (sec. 102). To achieve the necessary liquidity to effectuate a redemption that will qualify under section 115 (g) (3) the corporation may subject itself to the penalty tax of section 102.

(2) Section 115 (g) (3) does not include redemptions where stock in two or more corporations taken together comprise more than 35 percent of the decedent's gross estate.

(3) The present provision is not applicable where the estate-tax liability because of litigation cannot be determined within the period of 3 years and 90 days presently provided for redemptions.

The solutions that have been advanced to the above problems would be (1) to provide that section 102 liability will not be imposed if a corporation accumulates funds to effectuate a stock redemption quali-

fying under section 115 (g) (3); (2) to provide that where stock in two or more corporations in the aggregate comprise more than 35 percent of the decedent's gross estate, the redemption should qualify under section 115 (g) (3); (3) to provide that section 115 (g) (3) should include any redemptions made prior to the expiration of the limitations period including the period for which the limitations period is suspended by reason of an appeal to the Tax Court. Some have suggested greatly broadening the scope of section 115 (g) (3), substituting in lieu of its provisions a general exemption from capital gains tax on the sale of any assets by the decedent's estate up to the amount of death taxes imposed thereon.

Another taxpayer writes that there is a line of court decisions that is making it more difficult for a shareholder to redeem all of his shares in a closely held corporation and have that redemption treated as a capital gain rather than a distribution of earnings which would be taxed as ordinary income. It is suggested that the code should make it clear that in all cases where a shareholder's interest is liquidated completely, the gain should be taxed as a capital gain.

A number of taxpayers have suggested that the taxation of stock rights should be simplified. Under present law, where the stock rights do not constitute a taxable dividend, gain on the sale of the rights is determined by apportioning the cost basis of the original stock between such stock and the rights in relation to the fair market value of each when the rights are issued. Similarly, if new stock is acquired by exercise of the rights, the basis of the new and old stock must be adjusted to take into account the fair market value of the old stock and the rights when the rights are issued. It has been suggested that the problems of revaluing could be eliminated by treating the proceeds of the sale of rights as ordinary income with no adjustment in the basis of the stock. If rights are exercised, it is suggested that the purchase price alone be made the basis for the new stock with no adjustment to the basis of the old stock. Another taxpayer expresses the opinion that little revenue would be lost and needed simplification achieved by treating the sale of rights as a partial return of capital requiring the basis of the stock to be reduced by the amount of the proceeds from the sale of the rights. Another proposal would give the taxpayer the following alternatives:

(*a*) If rights are sold, permit the taxpayer (1) to report the proceeds as taxable income without adjusting the basis of his stock or (2) exclude the proceeds from taxable income and adjust the basis (unless such basis is zero) by the amount received from the sale of the rights.

(*b*) If rights are exercised, permit the taxpayer (1) to neither deduct the value of the rights from the basis of the old shares nor include them in the basis of the new shares or (2) to reduce the basis of the old shares and increase the basis of the new shares by the fair market value of the rights at the time the rights are exercised (unless the basis of the shares is zero).

12. Capital gains and losses (*sec. 117*)

Special provisions govern the tax treatment of gains and losses realized on the sale or exchange of capital assets.

Capital assets, generally speaking, constitute any property held by the taxpayer except (1) inventory or property held primarily for sale

to customers, (2) depreciable or real property used in the trade or business, (3) non-interest-bearing Government obligations, (4) copyrights and literary, musical, or artistic compositions.

Capital gains and losses are classified as either long- or short-term depending upon whether or not the capital assets are determined to have been held for more than 6 months. Gains and losses in each category must be aggregated to determine the net gain or loss. For example, long-term losses must be offset against long-term gains to determine the net long-term gain or loss.

If the net long-term gain exceeds the net short-term loss, the excess is taxed at a maximum rate of 26 percent. (If the taxpayer's marginal rate of tax on his ordinary income is less than 52 percent he is taxed at his marginal rate but only on 50 percent of the above excess.) If there is a net short-term gain, such gain is taxable in full at ordinary income rates. If the total capital asset transactions result in a net loss, such net loss is allowed to be carried over to the 5 succeeding taxable years to offset net capital gains in those years. In addition, for an individual taxpayer a net capital loss may offset ordinary income up to $1,000 (or to the extent of net income if net income is less than $1,000) in the year of the loss and any unused portion may be carried over and used as a similar offset in the 5 succeeding years.

Special provisions are contained in section 117 (j) for gains and losses resulting from involuntary conversions and from the sale or exchange of property used in the trade or business. If the total of such transactions results in a net gain, capital-gains treatment is provided; if a net loss, the ordinary-loss provisions apply. Property used in the trade or business includes, by definition, real or depreciable property held for more than 6 months which is used in the trade or business. It also includes under certain conditions timber, coal, unharvested crops, and livestock. The involuntary-conversion provisions apply to recognized gains or losses arising from the involuntary conversion of depreciable or real property used in the trade or business and held for more than 6 months and of capital assets held more than 6 months.

Although not a sale or exchange of a capital asset, the retirement of corporate bonds with interest coupons or in registered form is deemed by statute to be the equivalent of an exchange and therefore is given capital gain and loss treatment. Other transactions which receive similar treatment even though not strictly a sale or exchange include, under certain conditions, distributions in corporate liquidation, distributions from employee trusts, nonbusiness bad debts, securities becoming worthless, and others.

Among the criticisms which have been advanced concerning the present treatment of capital gains and losses are the following:

(1) The 5-year limitation on capital loss carryovers frequently prevents the taxpayer from receiving the full tax benefits of his capital losses.

(2) The present $1,000 limitation on capital losses is too low in view of the price-level changes that have occurred since this limitation was established.

(3) Corporations are denied deduction of the excess of net long-term losses over net short-term gains even though this excess results from ordinary business, as distinguished from speculative, transactions.

(4) The present holding period of 6 months is too long and is a deterrent to market liquidity.

(5) The present rule of tacking on the holding period of a noncapital asset which is exchanged for a capital asset offers a loophole for tax avoidance.

(6) The inclusion of gains and losses from involuntary conversions with gains and losses from the sale or exchange of property used in the trade or business commingles unfairly types of transactions which are essentially different in character.

(7) The provisions of section 117 (j) granting capital-gains treatment for livestock held for breeding purposes have been misconstrued by the courts. The courts have injected an age requirement not intended by the statute.

(8) The present rule of permitting bond retirements to receive capital-gains treatment even though the bonds were not originally issued in registered form has permitted the conversion of ordinary income into capital gains.

(9) The present rule for determining holding period and basis of fungible securities where identification is impossible imposes a heavy administrative burden on custodians to identify specific securities out of an interchangeable lot.

(10) Taxation of capital gains deters the free substitution of investment properties.

To remedy the above and similar difficulties envisaged in present law a wide variety of solutions has been suggested.

Some correspondents advocate abolishing the capital-gains tax. Others suggest reductions in the maximum capital-gains rate, varying from proposals of a 20-percent rate to as low as 2 percent. One taxpayer recommends that the capital-gains tax should be divorced from the income tax so that capital gains will not be taxed at the marginal rate while still another has proposed the following schedule of rates:

	Percent
First $1,000	15
Next $4,000	20
Next $10,000	25
Next $20,000	30
All over $35,000	35

Another would tie the rate to the holding period, taxing assets held less than 6 months at a rate of 50 percent, assets held 6 months to a year at a rate of 30 percent, assets held 1 to 2 years at a rate of 25 percent, with the rate declining 1 percentage point each year thereafter until the 26th year when no capital-gains tax would be imposed. One correspondent would grant preferential treatment to taxpayers 65 years of age or older and would tax them at only 10 percent on any capital gains where the assets had been held for 5 years or more. Another suggests that the capital-gains tax should be eliminated on property used in the trade or business on the theory that this treatment would help to meet the problem of inflated replacement costs. Another would amend the capital-gains provisions to tax as ordinary income any profits from speculation, arguing that taxpayers who make speculative trades in any commodity should not be allowed to pay any different tax than those who have ordinary earned income.

The holding period of 6 months has been the subject of a number of proposals. Some would reduce the holding period to 3 months

while others would eliminate it entirely. One taxpayer expresses the belief that there is no logic in the present 6 months' holding period other than that of a subsidy to the securities-trading industry. He indicates preference for the California income-tax law which, he states, taxes the following percentages of capital gains:

	Percent
Up to 1 year	100
1 to 2 years	80
2 to 5 years	60
5 to 10 years	40
10 years or longer	30

Another taxpayer offers the following scale for inclusion of capital gains:

	Percent
Up to 6 months	100
6 to 12 months	60
1 to 2 years	30
2 to 3 years	10
Over 3 years	No tax

Another recommends that capital gains on property held for more than 1 year should be spread evenly over the holding period so that the tax for year of sale would be limited to that which would have been payable if the profit had been received evenly over the holding period, 7 years being deemed the holding period if the asset had been held for more than 7 years. Another proposal relating to the holding period would provide that the holding period of an asset received in a tax-free exchange should include the holding period of the former asset only if the former asset was likewise a capital asset.

The restrictions on deductibility of capital losses have evoked a number of recommendations. Some taxpayers favor increasing the $1,000 limitation to $2,000, $3,000, or even $5,000 per year. Others would eliminate the 5-year restriction on capital loss carryover and instead permit capital losses to be carried forward until written off against either ordinary income or capital gain. Still others suggest that corporations should be allowed to deduct in full the excess of net long-term capital losses over net short-term capital gains. An alternative of this proposal would not restrict the deduction to corporations but would limit the tax benefit to the rate of tax applicable to the excess of net long-term gains over net short-term losses. Several taxpayers have protested that the changes made in the capital gains provisions by the Revenue Act of 1951 worked inequitably where a long-term capital loss was carried forward to years subsequent to the change. As a solution to this problem one taxpayer has proposed that in computing capital loss carryovers for years prior to the effective date of the 1951 act, gains and losses should be taken into account 100 percent.

Several correspondents have suggested changes in the treatment of short sales. One writes that the short seller is usually denied the benefit of long-term capital gain treatment even though he has maintained his short position for more than 6 months, whereas the purchaser who maintains a long position for 6 months or more is allowed long-term treatment. He contends that there is no sound reason why a seller on the short side who maintains his short position at the risk of the market for more than 6 months should not be taxed in the same

way as a person who maintains a long position. Another correspondent proposes repeal of the 1950 Revenue Act provision treating a put option as a short sale.

The provisions of section 117 (j) have been the subject of numerous proposed changes. It has been suggested that gains and losses from involuntary conversions should be separated from the other section 117 (j) transactions. Another suggestion is that property used in the trade or business should qualify for section 117 (j) treatment even though it has been fully depreciated. Somewhat akin to this proposal is the suggestion that section 117 (j) treatment should apply to property acquired for use in the trade or business even though not so used, provided the property has not been converted into investment property. Some have proposed that it should be made clear that livestock held for breeding purposes qualify for section 117 (j) treatment regardless of the age of such livestock when sold. Others recommend that the tax benefits accorded to raisers of livestock should be extended to raisers of poultry. One taxpayer expresses dissatisfaction with the provision of the Revenue Act of 1951 which extended section 117 (j) treatment to coal production under certain conditions. He suggests that this provision should either be eliminated or should be extended to all taxpayers Several corespondents have proposed that the holding period in section 117 (j) for timber should run to the date when the timber is cut instead of the date of the contract covering the sale of the timber. One correspondent expresses concern over the provisions of section 117 (j) permitting capital gains treatment for an unharvested crop sold with the land but requiring that the cost of producing the crop be treated as part of the cost of the land. He indicates that it is practically impossible to determine when a tree-produced crop starts since such crops are really inherent in the trees from the time the trees are planted. Another suggests that section 117 (j) treatment for the sale of livestock is too complex where the taxpayer is on the accrual basis. An extension of section 117 (j) treatment to loss on the abandonment of an option has also been proposed. Under this suggestion, if the taxpayer would have received section 117 (j) treatment had the property been purchased, he should also receive such treatment on abandonment of an option to purchase the property, thus being entitled to an ordinary loss instead of being limited to a capital loss.

Among the other suggestions for changes in the capital gains provisions is a proposal that interest on United States savings bonds be given capital gains treatment. Others suggest that corporate bonds and similar securities should not qualify for capital gains treatment unless such securities bear coupons or have been in registered form at least 6 months prior to their redemption. On the other hand, one taxpayer has advocated eliminating entirely the requirement that the corporate bonds and debentures bear interest coupons or be in registered form to qualify.

Another taxpayer suggests that statutory clarification is needed for the question of whether banks should be entitled to section 117 (j) treatment on property taken over in foreclosure.

One correspondent recommends that the difference in premiums paid and the maturity value of a life-insurance endowment contract which is presently taxed as ordinary income should either not be taxed or should be given capital gains treatment.

Another suggestion is that all royalties paid for the use of an individual's talent, such as inventions, literary or musical compositions, should be given capital gains treatment. A more limited proposal of a somewhat similar nature is that legislation should provide specifically for capital gains treatment where a patentee transfers all his rights in a patent and receives in payment indeterminate amounts from year to year during the life of the patent based on a percentage of the selling price of the patented devices. The courts have usually held that such amounts are viewed as installments of the purchase price if it was clear that a sale was intended, but the Bureau usually views the amounts as the equivalent of royalties and taxable as ordinary income.

Another suggestion would simplify administrative problems of taxpayers in identifying securities sold. Even though the securities are completely interchangeable for business purposes present law requires that the actual holding period and basis of the particular security sold be ascertained if possible. If identification is impossible, the taxpayer is deemed to have sold the first security acquired. It is suggested that the taxpayer should be permitted to designate the particular lot of securities sold for purposes of determining the basis and holding period and that this designation should control (provided satisfactory records are maintained showing the cost and date of acquisition of such lot) regardless of the certificate numbers of the securities comprising the lot.

A more sweeping proposal is the suggestion that the law should be amended to permit the tax-free exchange of securities for securities of a like kind. It is indicated that this latter suggestion would tend to eliminate the deterring effect of taxation on the free interchange of securities so that changes in investment portfolios would be motivated by business rather than tax considerations. A qualification of this proposal that is considered necessary to prevent tax avoidance is the provision for making the tax-free exchange of securities an elective provision but coupling the election with a tax imposed on the decedent's estate on the excess of the fair market value over basis of property acquired under the election, not to exceed the gain previously deferred.

Another broad proposal is the suggestion that capital gains realized by a corporate taxpayer should not lose their identity when distributed to stockholders. This proposal would extend to corporations generally the treatment provided in present law for regulated investment companies. Of more limited applicability is the suggestion that legislation should be enacted to overcome the recent decision of the Supreme Court in the *Arrowsmith* case (344 U. S. 6). Under that decision stockholders of a dissolved corporation who are compelled to pay back taxes of the corporation in years subsequent to the corporation's liquidation are limited to capital loss treatment on such payments. It is suggested that the taxpayer instead should either be permitted to reduce the income received from the dissolved corporation on liquidation by the amount of the additional taxes or he should be permitted to deduct the amount in full against other income in the year of payment.

A taxpayer who buys a piece of real estate for an investment and from time to time disposes of parts of it may be held by the Bureau to be in the business of dealing in real estate, but if such a taxpayer in-

vested in stocks and disposed of them at various times, he is not considered in the trade or business of buying and selling stocks. It is, therefore, suggested that the Bureau ruling be changed to eliminate this discrimination against the taxpayer who invests in real estate. In this same connection, dealers in securities are permitted under present law to hold some securities as a personal investment. Gains or losses on those securities which are held by the taxpayer in his capacity as a dealer are treated as ordinary income. However, capital gain or loss treatment is accorded the results of the sale of securities which the taxpayer holds as an investor. The Revenue Act of 1951 provided that, in order to qualify for capital-gain treatment in such cases, the security in question must have been clearly identified in the dealer's records for a specified period of time as "a security held for investment." This treatment is not available to corporations dealing in real estate, and it has been suggested that they be permitted, under a similar provision, to identify those parcels of land held for sale to customers and those held for investment. It is proposed that capital gain or loss treatment would then be available with respect to the latter properties.

13. Net operating loss carryovers and carrybacks (sec. 122)

Under present law a net operating loss may be carried back 1 year to reduce taxable income in such preceding year. If not used up in the carryback, the unused portion may be carried forward in sequence to the 5 years succeeding the taxable year.

The net operating loss is defined in section 122 as the excess of allowable deductions over gross income, with certain adjustments. The adjustments are intended, in general, to restrict the application of the net operating loss deduction to the economic loss incurred by the taxpayer. The adjustments (1) exclude percentage and discovery depletion in computing the depletion deduction, (2) include in gross income the amount of net tax-exempt interest, (3) exclude the net operating loss deduction, (4) take capital gains into account in full and capital losses to the extent of capital gains. Similar adjustments are made with respect to the year to which the net loss is earned. In the case of corporations, the dividends-received credit for the income year is, in effect, disallowed. In addition, for individual taxpayers the nonbusiness deductions (other than casualty losses) which are otherwise allowable are deductible only to the extent of nonbusiness income in determining the net operating loss.

It is indicated that the present net operating loss provisions fail to provide adequate relief in the following circumstances:

(1) Taxpayers with fluctuating income are unable to take advantage of the net operating loss deduction when adjustments are made for percentage depletion and exempt interest.

(2) Similarly, the restriction with respect to the dividends-received credit have the effect of depriving corporations with substantial dividend income of any benefit from the loss-spreading provisions of section 122.

(3) The limitations on deduction of nonbusiness losses for individual taxpayers (section 122 (d) (5)) have been restrictively interpreted to include losses incurred in partial or total liquidation of the business.

(4) The averaging period provided by the present 1-year carryback and 5-year carryforward of net operating losses is not deemed sufficient for taxpayers with a long business cycle. Extension of the carryback period is regarded as a desirable contracyclical device to cushion depression periods.

(5) The present averaging period does not take proper account of short taxable years.

A number of proposed solutions have been advanced to the above and related problems. Many taxpayers suggest that the economic-loss adjustments in section 122 should be eliminated. Others recommend that similar relief should be provided for taxpayers with relatively large proportions of dividend income by providing that the dividends-received credit should be taken as a deduction from gross income without restriction rather than as a restricted credit. One taxpayer suggests, as a matter of arrangement, that the limitations on the dividends-received credit should be set forth in section 122 rather than in section 26 (present law).

Another proposal that has been made by a number of taxpayers concerns the disallowance of losses incurred in the partial or total liquidation of a trade or business in computing the net operating loss deduction of a noncorporate taxpayer. The theory relied upon by the courts is that losses incurred in the liquidation of a business are not deemed to be losses attributable to the trade or business. This limitation is regarded as an arbitrary one by many taxpayers and it has been urged that legislation is necessary to overcome the effect of the court decisions on this point.

One taxpayer has suggested that recent legislation permitting the deduction of casualty losses in computing the net operating loss by individual taxpayers engaged in a trade or business gives such taxpayers an unfair advantage over salaried employees who may not carry forward casualty losses. He suggests that all taxpayers should be permitted to carry forward unused portions of casualty losses.

Another source of difficulty in the net operating loss provisions has been the effect on the limitation of corporate charitable contributions when a net operating loss is carried back to reduce net income in the preceding year. It is stated that the result is frequently to disallow charitable contributions which appeared to be an allowable deduction when made. It is suggested that the net income for the preceding year to which the net operating loss is applied should be net income after deduction of allowable contributions.

One taxpayer suggests that a solution is needed to the problem of the personal exemption and dependency credit in the year a net operating loss occurs. He indicates that the exemption and dependency credit operate to reduce the individual's net operating loss carryforward. Instead, he suggests, individuals should be permitted to carry back or carry forward the amount of their personal exemption and dependency credit along with the net operating loss.

Several correspondents have indicated that the present averaging period provided by the net operating loss provisions is not sufficient to fully provide for businesses with widely fluctuating incomes. Several suggest that the carryback period should be increased from 1 to 3 or 5 years. They state that the carryback is particularly important to cushion a business in a depression period, the carryback serving to reduce the severity of the depression phase of the cycle. Others

indicate the importance of increasing the carry-forward provisions from the present 5 years to either 6 or 7 years. Several suggestions indicate a preference for lengthening both the carry forward and carry back to give a total averaging period of at least 10 years. One taxpayer suggests that the net operating loss should provide for a full 84 months' averaging period for taxpayers having a carry back or carry forward to a short taxable year. Others have indicated a need for retroactive relief for fiscal year corporations who had operating losses in years prior to 1948.

14. Income in respect of a decedent (sec. 126)

Under section 126 items of gross income in respect of a decedent which are not properly includible in taxable periods prior to the decedent's death are includible for the taxable year when received by the estate or other person entitled thereto by reason of the decedent's death.

If the estate or other beneficiary, however, transfers the right to receive the income, the estate or other person, as transferor, must include in income the fair market value of the right to income so transferred or the consideration received, whichever is greater. It is not clear under present law whether the term "transfer" encompasses a bequest by the "transferor." For example, where a life-insurance agent has bequeathed to his wife his right to renewal commissions and his wife, in turn, bequeaths this right to her heirs, it is uncertain under present law whether the fair market value of the right to any remaining renewals is includible as income in the wife's final return. It has been suggested that this problem be clarified by amending present law to exclude from the term "transfer" any transfer by bequest, devise, or inheritance.

Another area of difficulty arising under the provisions of section 126 concerns payments to beneficiaries of a deceased employee under an employee retirement plan. Section 126 (c) provides for a deduction from taxable income in respect of a decedent of the amount of any estate tax attributable to inclusion of the right to this income in the decedent's gross estate. The Bureau has ruled that section 126 (c) is applicable to lump-sum payments made to the beneficiary of a deceased employee under a retirement plan but is not applicable to installment payments under such a plan. Where the installment payments are received under joint and survivor annuities, the problem is largely resolved by the provisions of section 113 (a) (5) added by the Revenue Act of 1951 giving the annuity the basis of its fair market value at the date of the decedent's death. With the exception of joint and survivor annuities, however, it has been proposed that installment payments to beneficiaries under a retirement plan should be allowed the deduction provided in section 126 (c). It has also been proposed that the present Bureau position on lump-sum payments should be affirmatively enacted.

An amendment to section 126 (b) has been advocated as a solution to a problem arising in connection with the basis of certain foreign personal holding company securities. Under present law, the basis of securities acquired from a decedent where the securities represent stock in a foreign personal holding company must be the fair market value of the securities when acquired from the decedent or the basis

in the hands of the decedent whichever is lower. It is indicated that this basis provision, which was originally enacted to prevent tax avoidance through the use of the foreign personal holding company device by American citizens, works a hardship in the case of aliens with personal holding company stockholdings who established residence in the United States during the World War II period. In some instances these resident aliens were unable to dispose of their foreign personal holding company stock prior to death. The stock was therefore includible in the decedent's estate for estate-tax purposes at its fair market value at date of death. For income-tax purposes, however, the stock takes the basis it had in the hands of the decedent. If the executor sells the stock to avoid imposition of the personal holding company tax, the estate gets no credit against the estate tax for the income tax so paid. It has been proposed in solution of this problem that the basis provisions in section 113 (a) (5) should be amended to make the basis for income-tax purposes the same as that for estate-tax purposes—fair market value at death—or alternatively that a deduction should be given under section 126 (b) equal to the excess of fair market value of the securities at death over their basis for determining gain or loss.

15. War losses (sec. 129)

A statutory presumption of the date when World War II losses occurred through destruction or seizure of property by enemy forces is provided by present law to eliminate the difficult burden of establishing the year in which such losses become deductible. The deduction is limited to the taxpayer's depreciated cost or other basis of such property.

On recovery of war losses the fair market value of the recovered property is taxed as ordinary income to the extent the deduction resulted in a reduction of tax. Under amendments added by the Revenue Act of 1951, a taxpayer may elect not to include the fair market value of recoveries in gross income but instead to recompute his tax liability for the years the war losses were deductible and to add any increased tax liability for such years to his tax liability for the recovery year. On recomputation of tax liabilities for the war-loss years, the taxpayer may reduce the war-loss deductions then taken by either the fair market value of the recovered property or its depreciated cost or other basis at the date of loss.

The above election for treating recoveries was required to be made in accordance with Treasury regulations and would apply to all war losses for all taxable years beginning after December 31, 1941. For recoveries prior to the Revenue Act of 1951 the election was required to be made prior to January 1, 1953. The election, once made, is irrevocable.

It is recommended that the time for making elections under section 127 (c) (3) should be extended at least until January 1, 1954, especially since the Treasury regulations under which elections had to be made were not proposed until less than 2 months before the time for making such elections expired.

It is also recommended that the war-loss provisions of section 127 should be extended to property seized or destroyed in the Far East by unfriendly governments since the outbreak of the Korean hostilities.

16. Employee stock options (sec. 130A)

Special tax treatment is accorded to employee stock options meeting the requirements of section 130A of the code enacted in the Revenue Act of 1950. If the stock option does not qualify under section 130A, the employee is taxable at ordinary income rates on the difference between his cost (consideration paid for the stock) and the fair market value when the option is exercised. In other words, the bargain purchase is treated as compensation to the extent that the employee is enabled to buy the stock at less than market price.

A qualifying or "restricted" stock option must meet the following tests: (1) The option price must be at least 85 percent of fair market value when the option is granted. (2) The option must be exercisable during his lifetime only by the employee. (3) The employee may not own, directly or indirectly, more than 10 percent of the total voting stock of the employer corporation or its subsidiaries.

If a taxpayer acquires stock under a restricted stock option and does not dispose of it within 2 years after the option is granted and within 6 months after the option is exercised, then no income results from the exercise of the option and no deduction is allowed to the corporation granting the option. However, if the option price was between 85 percent and 95 percent of the fair market value when the option was granted, the difference between the option price and such fair market value is taxable as ordinary income on disposition. Basis is increased by the amount so taxable.

The above tax treatment is not applicable unless the taxpayer exercises the stock option while he is an employee of the corporation or within 3 months after his employment terminates.

If a stock option is modified, extended, or renewed, a new option is deemed to be granted. In such cases, the fair market value of the stock when option was granted is deemed to be the highest of (1) value when option was originally granted, (2) value when option was modified, extended, or renewed, (3) value when any intervening modification, extension, or renewal of the option was made.

The stock-option provisions have been criticized on the following grounds:

(1) It is not clear whether a deceased employee's estate may exercise a restricted stock option.

(2) An option to acquire stock at a fixed percentage of market price for a limited period does not come within the restricted stock-option provisions.

(3) The present rules are too inflexible to satisfactorily provide for noncompensatory stock options issued to obtain new equity capital and to increase employee ownership of the business.

(4) The valuation rule for modifications, extensions, or renewals of stock options virtually prohibits such changes.

As a solution to one of the above problems, it has been suggested that section 130A should be amended to provide that a restricted stock option may be exercised by the estate of a deceased employee within a specified period following his death.

It has also been proposed that section 130A should include within the definition of a restricted stock option an option expressed as 95 percent of fair market value on acquisition where such option may only be exercised within a limited period. One taxpayer suggests

that the percentage limitation of 85 percent to qualify as a restricted stock option should be reduced to 70 percent.

A more fundamental change proposed in present law would be to include within the definition of restricted stock options a noncompensatory employee stock-purchase plan subject to restrictions as to number of shares, percentage of employee's total compensation, and percentage of total shares offered.

Others have suggested that treatment of modifications, extensions, and renewals of options should be limited to simply treating any such modification, extension, or renewal as a new option.

The question of stock options which were granted before the effective date of section 130A has been the subject of several recommendations. One proposal would provide that these presection 130A options should not be deemed taxable income to the recipient employee until the stock is sold. This proposal is grounded on the argument that the employee otherwise may have to sell the stock in order to pay the tax. Another proposal deals with pre-section 130 A options which would otherwise qualify as restricted stock options except for their assignability feature. (As pointed out above, a restricted stock option may not be assignable.) It is indicated that if such options are made nonassignable to qualify as restricted options, the modification is treated as a new stock option with fair market value being taken into account at that time. It is consequently recommended that options granted prior to the Revenue Act of 1950 should be permitted to be modified to qualify as restricted stock options without being treated as new options.

17. Consolidated returns (sec. 141)

Under present law an affiliated group of corporations may elect to file consolidated returns if all members of the group consent to the consolidated return regulations. An additional tax of 2 percent of surtax net income (except for income attributable to Western Hemisphere trade corporations) is imposed when consolidated returns are filed. Also, the minimum excess-profits credit is $25,000 for the affiliated group and not $25,000 for each member of the group.

An affiliated group is defined as one or more chains of corporations connected through stock ownership with a common parent. To be includible in the affiliated group 95 percent of the stock of a corporation must be owned by the parent or other member of the group. Certain corporations, such as foreign corporations, may not qualify as includible corporations.

The following features of the consolidated-returns provisions and regulations are deemed objectionable:

(1) The 2-percent tax imposed when consolidated returns are filed is deemed an arbitrary and unnecessary exaction for reporting income in a manner that most clearly reflects the true income of the business enterprise.

(2) Inclusion of lessor railroad companies as members of the affiliated group is not permitted even though the operating lessee railroad is required by the lease to pay the taxes of the lessor.

(3) The consolidated-returns regulations disallow application of the unused excess-profits credit of one member of an affiliated group against the excess-profits net income of another member where affilia-

tion took place after March 14, 1941. The latter date bears no relationship to the Excess Profits Tax Act of 1950 but is a retention of the World War II provision.

(4) Intercompany profits in inventory may be subject to double taxation under the consolidated-returns regulations when corporations change from separate to consolidated returns.

(5) The consolidated-returns regulations make the election to file consolidated returns binding except under certain conditions which are not determinable in advance.

To meet the above and similar objections, a number of changes have been proposed in the consolidated-returns provisions. The proposal that has been advanced by the greatest number of correspondents is that the 2-percent additional tax for filing consolidated returns should be eliminated. A variation of this proposal is the suggestion that the 2-percent tax be eliminated if the affiliated group elects to file a consolidated return permanently or that a graduated surtax (1 percent to 5 percent) be imposed where the election is not permanent but optional each year, the rate depending upon the tax reduction afforded by consolidation. Another suggestion is that the 2-percent tax be eliminated and that the tax on intercompany dividends be eliminated except that corporations who are eligible to file consolidated returns and fail to do so would be required to pay the tax on 15-percent intercompany dividends. A variation of this latter proposal is the suggestion that the 2-percent tax be eliminated and consolidated returns be made compulsory for those eligible to file such returns. One taxpayer has suggested that the provisions for filing consolidated returns be eliminated from the code.

The problem of affiliation has been the subject of several proposals. One recommendation would reduce the requirement of 95 percent ownership of voting stock to 50 percent. Another suggestion would treat preferred stock in the case of utilities as nonvoting stock even though such stock actually possesses voting rights. In support of this proposal it is stated that preferred stock of utility subsidiaries must frequently carry voting rights under State law or regulatory provisions, and as a result the subsidiary does not meet the test of affiliation even though the parent owns 100 percent of the subsidiary's common stock. An analogous problem is the lessor railroad which forms a part of the integrated operating unit of the lessee railroad corporation. Under the terms of the lease the lessee may be required to pay all the taxes of the lessor company, yet cannot include the lessor in its (the lessee's) consolidated return. It is therefore proposed that a lessor railroad company should qualify as a member of the affiliated group for filing consolidated returns if the lessee is required by the lease to pay the taxes of such lessor.

Several correspondents have recommended that the election to file a consolidated return should be made an annual election by specific statutory provision. Others propose that the original election to file a consolidated return should be an option exercisable by the taxpayer so long as its tax return for the year of election remains open. It is stated in connection with the above proposals that the present regulations, preventing affiliated groups that have previously elected to file consolidated returns from changing their election in subsequent years except under specified conditions, are unduly restrictive.

Others have suggested a statutory amendment to make clear that intercompany profits in inventory should not be subject to double taxation when changing from filing separate returns to the consolidated method. An amendment to the Consolidated Returns Regulations has been proposed that would provide that the unused excess-profits credit should not be disallowed for affiliated groups formed prior to July 1, 1950.

18. Estate and trust income (*secs. 161 through 172*)

Under present law trusts and estates are treated as separate taxable entities with their own deductions and with their returns made by the fiduciary (supplement E of the code).

The net income of an estate or trust is computed in the same manner as an individual with the following exceptions:

(1) The standard deduction is not allowed.

(2) An unlimited charitable deduction is allowed unless the trust has engaged in certain prohibited transactions.

(3) An estate may not deduct casualty losses if such losses are claimed as a deduction for estate-tax purposes.

(4) An additional deduction is allowed to the trust or estate for income which is properly paid or credited to the beneficiary, heir, or legatee or for income which is currently distributable. Such distributable income is then includible in the net income of the beneficiaries, heirs, or legatees whether distributed to them or not. In determining whether an additional deduction is allowed, amounts which are distributable out of income or corpus (with certain exceptions as to gifts and bequests) are deemed to be distributable from income to the extent of the current distributable income. Where amounts are distributable out of income of a prior period, distributions within the first 65 days of the taxable year are deemed to have been distributed on the last day of the prior year to the extent of available income for the prior period not exceeding 12 months.

The exemption for estates is the same as that for individuals ($600) but the exemption for trusts is limited to $100.

The following objections to the estate and trust income tax provisions have been raised:

(1) Taxation of trust income under the general taxing provisions of section 22 (a) (*Helvering* v. *Clifford* (309 U. S. 331 and similar cases)), has left uncertain the question of when the specific rules for taxing trust income under supplement E apply.

(2) The 65-day and 12-month rules for the determination of distributable income are complex and difficult to apply.

(3) Beneficiaries may be taxable on distributions which are in excess of the taxable income of the trust or estate (cf., *Johnston* v. *Helvering* (141 F. 2d 208), *McCullough* v. *Commissioner* (153 F. 2d 345), *Plunkett* v. *Commissioner* (118 F. 2d 644)).

(4) The $100 exemption for trusts is too low.

A number of proposals have been received dealing with these problems. Some correspondents suggest that supplement E should be amended to provide that taxation of estate and trust income should be determined exclusively under its provisions and not under the general provisions of section 22 (a) or any other section. One taxpayer has proposed enactment of statutory rules for the taxation of Clifford-

type trusts. He recommends that the income of such trusts should be taxed to the grantor only if (*a*) the trust assets must revert to the grantor or his estate in less than 5 years or must be disposed of as he directs, or if (*b*) the grantor retains the power to designate who is to receive the trust income.

Many taxpayers have suggested that the rules for determining whether trust and estate income is taxable to the fiduciary or to the beneficiaries should be clarified and simplified. It is specifically proposed that the complex 65-day and 12-month rules should be eliminated and that the amount includible in the income of the beneficiaries should not exceed the net income of the trust or estate. It is also recommended that any amendment should make clear that the income in the hands of the beneficiaries retains the same character it had in the hands of the fiduciary so that the statutory purpose of treating the estate or trust as merely a conduit is achieved. It is further suggested that the trust and estate provisions should make clear that items such as capital gains which are treated as items of principal under State law are taxable to the fiduciary unless the will or trust instrument specifically provides for their distribution to the beneficiaries.

The treatment of capital gains in the year the trust terminates and is distributed has been mentioned as being especially in need of clarification. It is suggested that if such capital gains should be regarded as taxable to the distributee, there should be a definite event, such as the death of the life beneficiary, approval by the probate court of the fiduciary's accounting or approval of a schedule of distribution which would determine whether the sales of the trust assets should be regarded as made by the fiduciary (and taxable to him) or made for the distributee. It is further suggested that if all capital gains realized subsequent to the death of the life tenant are treated as taxable to the distributee, any administrative expenses occasioned by the death of the life tenant should be deductible by the distributee.

Several correspondents have suggested that the trust exemption should be increased from $100 to $300 or even $600 to eliminate the necessity of paying tax where an insignificant amount of income is taxable to the fiduciary. Others have proposed that trustees' commissions should be deductible from distributable income where there is not sufficient income taxable to the fiduciary to receive any tax benefit from the deduction of the commissions by the fiduciary.

A special problem under the estate and trusts provisions is the taxation of discretionary insurance trusts. Under present law where the income of a trust is held for future distribution to the grantor or is distributable to him, either at his discretion or the discretion of a person not having a substantial adverse interest in the income, such income is taxable to the grantor. Similarly, if the income is applied to the payment of insurance premiums on the grantor's life or may be so applied in the discretion of the grantor or interested fiduciary, the income is taxable to the grantor.

It is urged that the income of discretionary insurance trusts should be taxed to the grantor only if the trust income is actually used to pay insurance premiums on policies on the grantor's life.

19. Partnerships (secs. 181 through 191)

Partnerships, under present law, are required to file an income-tax return which is, in fact, only an information return which the

Bureau uses when it examines the individual returns of the partners. The partnership, as such, is not subject to income tax, but each partner is taxed on his pro rata share of the partnership income which he includes in his individual tax return. Such partnership return shows all the income and deductions attributable to the partnership and is very similar to the return required by an individual in a trade or business.

There are several points of difference, however. For example, capital gains and losses of the partnership are not included in the partnership income but are carried into the income of the individual partners according to their distributive shares. Similarly, the individual partners take directly their distributive shares of partnership contributions and of any net operating loss carryover.

The suggestions relating to improvements in the tax treatment of partnerships have been principally concerned with two major problems. The first of these deals with the difficulties encountered by the partnership that attempts to retain part of its earnings to provide for expansion of the business or to cushion depression periods. The second major problem deals with change in composition of the partnership by reason of either death or withdrawal of one of the partners.

As to the first problem, the solution most frequently advanced is that partnerships should be given the option to be taxed as corporations. It is pointed out that while corporations are taxed on all their earnings, taxation is at corporate rates rather than at individual rates. Undistributed corporate earnings which are plowed back into expansion of the business are not taxed to the shareholders. The entire partnership income, on the other hand, is taxed to the partners at individual rates even though part of the income is retained by the partnership. One correspondent would give partnerships the option to be taxed as corporations but would allow credit for the distribution of profits to individual partners. Another proposed solution is the suggestion that individual partners should not be taxed on their proportionate share of partnership earnings unless these earnings are actually distributed. It is argued that taxation of partners on earnings which are accumulated for expansion of business creates a hardship as to the partners and deters business expansion. A somewhat different approach to the problem is the suggestion that income from partnerships should be taxed at a substantially lower rate than individual income. For example, it has been proposed that the first $50,000 of partnership income should be exempt from tax, that the next $50,000 should be taxed at a 20-percent rate, that the partnership should be allowed to deduct each year a reasonable amount to provide against future losses, and that it should also be allowed to deduct up to a maximum of $25,000 annually to provide for future business expansion. In support of this proposal it is argued that small and new businesses would thus be encouraged to expand in order to compete successfully with large corporations and would be enabled to build up a reserve to provide for bad years in the future. A proposal that does not deviate quite so far from present law is the suggestion that partnerships should pay the income tax on partnership income, the partnership then charging the individual partners for their share of the income tax. Each partner would then make his own return exclusive of the partnership profit. An even more restricted proposal is the suggestion that the

balance sheet on corporate returns should be eliminated, requiring the partners to report the true net income only. One correspondent recommends that the salaries drawn by each partner should be deductible expense from the partnership income instead of the present practice of treating such salaries as a distribution of partnership profits. Others have suggested that donations by partnerships should be deductible from the partnership's income rather than the provisions of present law requiring that the contributions be taken on a pro rata basis by the individual partners on their individual returns. It is contended that this proposal would simplify reporting.

On the second major problem—change in composition of the partnership—a number of proposals have been received. Several have emphasized the need for legislative clarification of the tax status of amounts paid under the terms of the partnership agreement by surviving partners to the estate or heirs of a deceased partner. It is indicated that the court decisions have been conflicting in their approach to this problem. It has been suggested that the most equitable approach would be to tax such income to the person or persons receiving it and to eliminate the amounts so paid from the taxable income of the surviving partners. On the more limited question of reporting of partnership income that is earned prior to the death of a partner, it has been suggested that the partnership be given the option of reporting the distributive share of profits to the deceased partner's estate at the end of the regular accounting period. In support of this proposal it is indicated that under present law a partnership with a fiscal year ending January 31 and the partners reporting on a calendar year, requires the taxing of from 12 to 23 months income in 1 year in the event of the death of a partner.

On the question of the basis of the partner's interest in the partnership assets when a change in the composition of the partnership is affected by the death or withdrawal of a partner, one correspondent writes as follows:

> In the past few years, various court decisions have treated partnerships very similar to corporate entities and this is entirely contrary to the original tax concept of partnerships. The original concept was that each individual partnership owned an undivided interest in each and every asset and that his basis of cost in those assets would remain unchanged when the partnership was terminated. Gradually the theory has been built up that each partner has a certain investment in the overall partnership assets and that on liquidation this equity must be distributed pro rata over the value of the assets received. The next logical step would be to hold that an individual would receive a profit on the termination of a partnership if the assets of the partnership have enhanced in value. It would seem that the original concept of partnerships followed by the Treasury Department in the early years of the income-tax law is far better than the concept as it is being gradually developed by court decisions. The only way to get back to the original concept is by some definite legislation.

The following miscellaneous suggestions have been made in connection with the taxation of partnerships:

(1) It is recommended that the law covering the filing of partnership returns should make it mandatory that every venture involving two or more persons must file a partnership return. Inasmuch as a partnership return is only an information return, some substantial penalty should be provided applicable to every member of the group for failure to file.

(2) The rules evolved in the Revenue Act of 1951 for the taxation of family partnerships should be made retroactive to all prior years

and special legislation should be enacted permitting refund claims for years now barred by the statute of limitations.

(3) Closely held corporations which would qualify as personal holding companies with respect to the stockholding requirement should be given the option to elect irrevocably to be taxed as a partnership.

(4) All partnerships and unincorporated business of a net investment of $10,000 or more should be taxed as corporations.

20. Nonresident aliens (sec. 211)

Under present law, nonresident aliens who are temporarily within the United States rendering service to a foreign subsidiary of a domestic corporation are not taxed on income received therefrom provided they are not present in the United States for more than 90 days during the taxable year and provided that their total compensation for services rendered in the United States does not exceed $3,000 (sec. 211 (b)).

Where nonresident aliens are engaged in business within the United States, their wages or salaries are subject to withholding at the rate of 30 percent.

It is suggested that the nonresident alien employee of a foreign branch of a domestic corporation should receive the same treatment as a nonresident alien employee of a foreign subsidiary. It is therefore recommended that the benefits of section 211 (b) should be extended to nonresident alien employees of domestic corporations who perform temporary services within the United States for periods less than 90 days in the taxable year and for which the compensation is $3,000 or less. Some taxpayers have suggested that the $3,000 ceiling in section 211 should be raised. It is also suggested that the withholding rates for United States citizens should be applicable to nonresident aliens temporarily employed in the United States.

It has also been proposed that no United States tax should be withheld on motion-picture rents and royalties paid to nonresident aliens. The reason advanced for this proposal is the contention that the present system of withholding on motion-picture rents and royalties paid to nonresident aliens encourages foreign countries to tax gross film rentals and makes it difficult for domestic motion-picture companies to do business abroad.

21. Personal holding companies (secs. 500 through 511)

A penalty tax is imposed in chapter 2 of the Internal Revenue Code upon corporations falling in the classification of personal holding company at the rate of 85 percent of "undistributed subchapter A net income" (75 percent of such income under $2,000). The tax is in addition to all other taxes except the penalty tax on unreasonable accumulations of surplus.

A corporation is not deemed by statute to be a personal holding company unless both the "gross income" and "stock ownership" tests are met. Certain corporations, such as life-insurance companies, licensed personal finance companies, etc., are specifically exempted.

In general, a corporation does not fall within the statutory definition of a personal holding company unless 80 percent or more of its gross income is derived from dividends, interest, royalties, annuities, gains from sale or exchange of stock or securities, gains from futures transactions in commodities, income from estates and trusts, amounts

received under personal service contracts, compensation for use of corporate property by shareholder, rents, and mineral, oil, or gas royalties. Many of the above are subject to substantial limitation. For example, rental income is not includible if it constitutes 50 percent or more of gross income. Similarly, amounts received under personal service contracts are not includible if the person who is named in the contract to perform the service owns, directly or indirectly, less than 25 percent of the corporation's stock.

Even if a corporation has more than 80 percent of its income from the above sources, it will still not be taxed as a personal holding company unless at some time in the last half of its taxable year 50 percent or more of its stock is owned, directly or indirectly, by or for not more than 5 individuals.

Where railroad corporations file consolidated returns, the affiliated group is not subject to personal holding company tax unless the common parent meets the stock ownership test and the gross income of the group meets the gross-income test.

When a corporation does fall within the statutory definition of a personal holding company, the penalty tax is imposed on its "undistributed subchapter A net income." The latter is determined by adjustments to taxable net income. These adjustments include additional deduction of income and excess-profits taxes, allowance of deduction for charitable and other contributions up to 15 percent of corporate net income, and the dividends-paid credit. The dividends-paid credit includes consent dividends, thus permitting a personal holding company to obtain credit without an actual payment of dividends. The consent-dividends procedure allows the corporation credit for amounts which its shareholders consent to include in their taxable income.

Subject to certain restrictions, the personal holding company may take credit for dividends paid within 2½ months after close of the taxable year. In addition, the corporation may receive partial credit for dividends paid after a penalty tax has been determined. Such deficiency dividends must comply with the statutory requirements.

The following objections have been raised to the personal holding company provisions:

(1) The gross income test for determining whether a corporation falls within the personal holding company definition may subject a corporation to the penalty tax where it has losses on sales and a relatively small amount of personal holding company income.

(2) The personal holding company provisions for railroad corporations filing consolidated returns should not be restricted to railroad corporations.

(3) The 15 percent limitation on deductions for charitable and other contributions was not raised to 20 percent when the limit for individuals was so raised.

(4) The deduction for income taxes should be for taxes imposed for the taxable year whether the taxpayer is on the cash or accrual basis and should not, as under present law, depend upon the taxpayer's method of accounting.

(5) The consent dividends procedure has not been extended to deficiency dividends.

(6) The deficiency dividend procedure is not permitted except where failure to file a personal holding company return is not due to

fraudulent intent to evade tax or to willful neglect. Under the present provisions the taxpayer must show that its failure to file the return was due to reasonable cause.

(7) The dividend-paid credit is not allowed for distributions in liquidation.

A number of solutions have been put forward to meet the above objections and related problems.

Several correspondents have suggested that the phrase "gross receipts" should be substituted for the phrase "gross income" in the applicable sections of the personal holding company provisions to prevent imposition of the tax where the corporation's losses from sales cause a relatively small amount of personal holding company income to bring the corporation within the definition of a personal holding company. One taxpayer has suggested that corporate profits which are used to repay indebtedness should be excluded from "undistributed subchapter A net income" in the same manner that taxes and dividends are excluded. Others have suggested permanent enactment of the provisions of section 223 of the Revenue Act of 1950 which excluded from the definition of personal holding company income for the years 1946–50 rents received by a corporation for the use of its property by one of its shareholders in a bona fide business enterprise. Another taxpayer has suggested that the provisions of the above section should be made retroactive to all years prior to 1950. It has been proposed that the 15-percent limit on charitable contributions by personal holding companies should be increased to 20 percent. Another recommendation would extend the consolidated-returns provision to all corporations and not limit its applicability to railroad corporations. Several correspondents have proposed that Federal income and excess-profits taxes for the taxable year should be deductible in computing "undistributed subchapter A net income" regardless of a taxpayer's method of accounting. Others have recommended that the statute should make it clear that a deduction for income taxes paid by personal holding companies may give rise in a proper case to a net operating loss credit (under the special provisions of section 26 (c)) which may be carried forward to the following year.

The deficiency-dividend procedure has been the subject of several suggestions. It has been proposed that the consent-dividends procedure should be applicable to deficiency dividends. Another suggestion is that the deficiency-dividend procedure should be authorized whenever a personal holding company tax deficiency has been assessed, thus eliminating the requirements of a closing agreement or a Tax Court decision. It has been recommended that deficiency dividends should be permitted except where the failure to file a return is due to fraud. The present provision requiring the taxpayer to show that his failure to file a return was due to reasonable cause may preclude use of the deficiency-dividend procedure where the failure to file a return was the result of mere inadvertence.

A change in the consent-dividends procedure has also been suggested. It would provide that where stockholders have filed consents agreeing to include in taxable income an amount then deemed sufficient to eliminate personal holding company surtax, any additional personal holding company income for such years should be deemed to have been covered by such consents and taxable to the stockholders in

such year rather than in a later year when deficiencies are determined, even though they did not in the earlier years specifically consent to the inclusion of such additions. This proposal is deemed necessary to cover the situation where stockholder consents have been filed in amount sufficient to eliminate the surtax, but subsequent adjustments upon audit of the return result in increased taxable income and thus a personal holding company tax deficiency with interest.

Several correspondents have indicated that the following situation is not uncommon: A personal holding company which is completely liquidated within the taxable year, which has a nonallowable capital loss in excess of its subchapter A income for the year, and which has no accumulated earnings for prior years, finds itself in the position, under a strict interpretation of the code, of having to pay the personal holding company surtax on its current year's subchapter A net income, despite the fact that it distributes all of its assets to its stockholders in liquidation. This result is brought about by the fact that a corporation in liquidation can obtain a dividends-paid credit only for distributions which are properly chargeable to accumulated earnings. The capital loss, while not deductible for personal holding company tax purposes, must be deducted in computing earnings and profits. To remedy this situation, it is proposed that the dividends-paid credit should be applicable to distributions in liquidation (at least to the extent of the corporation's subchapter A net income).

One taxpayer suggests that the Canadian practice of taxing personal holding companies as partnerships should be adopted in this country. He indicates that adoption of this proposal would enable taxpayers to invest in Canadian securities through the medium of personal holding companies without being subject to Canadian succession taxes. Another taxpayer suggests that corporations with net income of less than $25,000 should be exempt from personal holding company taxation. Another recommends making the personal holding income-tax return a supporting schedule to the corporate income-tax return so that the statute of limitations will run and the penalty tax will not apply where the failure to file is due to inadvertence and is not fraudulent.

22. Miscellaneous

(*a*) *Recovery of taxes previously deducted* (*sec. 128*).—Under section 128 a taxpayer may exclude from income unconstitutional Federal taxes previously deducted, provided he waives the statute of limitations and treats the prior deduction as disallowed. It has been suggested that this provision should be extended to the recovery of any taxes previously deducted. In effect, this suggestion would extend the tax benefit rule of section 22 (b) (12) to provide that the tax benefit would be taxed at the rates prevailing at the time the tax was originally deducted rather than the rates in effect at the time of recovery.

(*b*) *Acquisitions to avoid tax* (*sec. 129*).—Where a corporation is acquired after October 7, 1940, for the purpose of evading or avoiding Federal income or excess-profits taxes by securing deductions, credits, or allowances to which the acquiring taxpayer would not otherwise be entitled, such deductions, credits, or allowances are disallowed by section 129 of the code.

It has been stated that the above provisions of section 129 are too vague and uncertain to warrant continuing the provision as a permanent part of the code.

One correspondent states that he has "received several letters from agents who have indicated that they are interested in purchasing corporations with loss carryover possibilities." Judging from the efforts of these promoters to acquire companies in financial distress for tax-saving purposes, he concludes that present law must contain a loophole and that corrective legislation to stop such acquisitions is necessary.

(*c*) *Repayment of profits under section 16 (b) of the Securities and Exchanges Act of 1934.*—Under section 16 (b) of the Securities and Exchanges Act of 1934, corporate officers and directors are required to pay over to the corporation any profits they realize by virtue of their office on dealings in the corporation's stock. Recent decisions indicate that a corporate director or officer who repays such profits is not entitled to any tax benefit on repayment. The corporation receiving such payments must include them in taxable income.

It is urged that the rule laid down by recent decisions is inequitable in instances where infractions of section 16 (b) of the Securities and Exchanges Act were inadvertent and that too severe a penalty is imposed when the taxpayer must pay a tax initially on his profits but is denied any deduction or other relief when compelled to disgorge such profits. It is recommended that the repayment of profits should either be an adjustment of the basis of the taxpayer's stock or a short-term capital loss in the year of repayment.

(*d*) *Witholding on tax-free covenant bonds* (*sec. 143*).—Where corporate obligations issued prior to 1934 contain a clause providing that interest will be paid without deduction of any taxes imposed on the obligor, the obligor corporation is required to withold 2 percent of the interest so paid (30 percent in the case of nonresident aliens) by section 143 of the code. The 2 percent tax may be taken as a credit by the bondholder. If the bondholder has no taxable income, the corporation may receive a refund of the tax.

It is stated that this withholding tax imposes an expensive administrative burden on the withholding corporation with a resulting loss of revenue. It is recommended that the tax should be borne by the bondholder, not by the corporation, since the corporation is obligated to pay the tax only by reason of this anachronistic feature of the tax law rather than by reason of any contractual obligation.

(*e*) *Trusts taxed as corporations.*—Section 3797 (a) (3) states that the term "corporation" includes associations, and thus any organization that is an association is taxable as a corporation. However, there is no statutory definition or description of what an "association" is. Following various court decisions, especially the Supreme Court's decision in the *Morrisey* case (296 U. S. 344), Treasury regulations define "association" to include a trust or any other entity—

created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a Board, or some other group.

It is contended that such a definition goes beyond congressional intent, in that Congress intended to tax as a corporation only an entity, which, though actually a corporation, to avoid the corporation taxes sets up a sham organization not nominally a corporation. Further, it is stated that such a definition provokes much litigation, much of which

results in decisions against the Government's position. It is therefore suggested that the code provide a definition or description of "association" which will be precise, and which will exclude bona fide trusts and other entities which are not sham corporations.

Other taxpayers have urged that real-estate trusts with transferable shares should not be taxed as corporations but should be given the same tax treatment that is presently accorded to regulated investment companies. (See explanation of the taxation of regulated investment companies under (f) below.) In support of this proposal it is stated that the purpose of real-estate trusts is to provide unified management of real-estate properties much as regulated investment companies provide unified management and diversification in securities investment. It is further contended that these real-estate trusts ordinarily distribute substantially all their income to the beneficiaries, thus serving largely as conduits of the income. For these reasons, it has been proposed that real-estate trusts with transferable shares should be taxable in the same manner as regulated investment companies.

(*f*) *Regulated investment companies* (*secs. 361 and 362*).—Regulated investment companies may elect to be taxed under supplement Q which, in general, provides that they are exempt from the corporate tax on that part of their net income which is distributed, provided at least 90 percent of their total net income (exclusive of capital gains) is distributed to shareholders. If capital gains are distributed to shareholders, the regulated investment company escapes capital-gains tax and the dividends so paid out of capital gains are taxed to the shareholders as capital gains and not as ordinary income.

The problem, it is said, which the regulated investment companies face under the present supplement Q provisions relates to the sizable unrealized appreciation in the security portfolios of these companies. Distribution of any sizable capital gains dividend tends to distort the market price of a regulated investment company's stock. The distribution may create a false picture of future prospects when the distribution, in fact, represents a reduction in the company's portfolio. These considerations, it is stated, may unduly influence the management in its decision to realize or fail to realize the appreciation in securities which would otherwise be disposed of in the exercise of sound investment policy.

It is argued that such capital gains should be realized but that they should be retained as part of the investment fund. Present law, however, discourages retention by subjecting retained capital gains to double taxation, the tax being imposed directly on the capital gains kept by the company and indirectly on the proceeds realized by the stockholder when he subsequently disposes of his shares. The solution proposed is twofold. First, as to open-end investment companies (companies whose shares may be redeemed by the holder at their net asset value), it is suggested that the problem can be solved by making stock dividends by such companies taxable when distributed as capital gains dividends. Secondly, as to closed-end companies (companies that are not required to repurchase their outstanding shares) the solution suggested is to tax undistributed capital gains only to the shareholders, with maximum capital gains tax being withheld by the company and paid over to the Treasury, the shareholder receiving credit for the tax so paid. It is thought that both of these solutions would

result in maximum retention by the investment companies of realized capital gains and thus maintenance of their portfolio levels but that the capital gains would be taxed as though received by the stockholders. It is contended that the difference in approach between the open-end and closed-end companies is required by the fact that open-end shares sell at their net asset value whereas closed-end shares generally sell at a discount.

Another more limited suggestion in regard to regulated investment companies is the proposal that dividends paid after the close of the taxable year but declared prior thereto should be treated in the same manner as dividends paid and declared after the close of the taxable year. Section 362 (b) (8) permits regulated investment companies under certain conditions to treat dividend distributions made *after* the close of the taxable year as having been paid *during* the taxable year. It has been indicated that the present language in the above section does not make it clear that this treatment may be accorded to dividends paid after the close of the taxable year but declared prior thereto. It has therefore been suggested that appropriate language should be added to the above section to clarify the treatment of such dividends.

(*g*) *China trade corporations*.—Under section 3805 of the code, income tax returns for the years 1949 through 1952 for corporations organized under the China Trade Act of 1922 are not due until December 31, 1953.

It has been recommended that the above date be extended for 3 years.

II. Estate and Gift Taxes

A. ESTATE TAX

1. Transfers in contemplation of death (secs. 811 (c) (e))

Under present law transfers made in contemplation of death are includible in the decedent's gross estate, but transfers made by the decedent more than 3 years prior to his death cannot be held transfers in contemplation of death. Where the transfer occurred within the 3-year period prior to death the estate has the burden of showing that the transfer was not made in contemplation of death. The present rule was enacted by the Revenue Act of 1950. Under the law existing prior to that act a transfer might be held in contemplation of death regardless of when made and the statute set forth a rebuttable presumption that transfers within 2 years prior to death were made in contemplation of death. One taxpayer has suggested that the changes made by the Revenue Act of 1950 should be made retroactive to years prior thereto. Others have suggested that the inclusion in the gross estate of transfers in contemplation of death should be limited to gifts causa mortis. Another proposes that gifts coming within the specific exemption or annual exclusion from gift tax should be exempted from the contemplation of death provisions.

2. Retention of life estate (sec. 811 (c))

Under existing law any transfer of property in trust or otherwise made by a decedent in which he has retained a life estate makes such property includible in the decedent's gross estate. Until the decision of the Supreme Court in *Commissioner* v. *Estate of Church* (335 U. S.

632), however, the corpus of an irrevocable trust created prior to 1931 in which the settlor had retained a life estate was held not to be includible in the decedent's gross estate. When the Supreme Court held taxable such pre-1931 transfers in the Church case, the Technical Changes Act of 1949 was enacted to overcome the effect of the Church decision. It provided that retention of pre-1931 life estates would not make such property includible in the gross estates of decedents dying before January 1, 1950. The Revenue Act of 1951 extended the above date of January 1, 1950, to January 1, 1951. It was also provided that such life estates could be released free of estate and gift tax at any time during 1949 or 1950.

A number of taxpayers have indicated that the relief provided from the effect of the Church decision by the Technical Changes Act of 1949 and the Revenue Act of 1951 was not sufficient. It has been stated that many aged settlors were unable to release retained life estates within the limited time allowed either through lack of knowledge of the relief provisions or because of legal disability. It has therefore been proposed that the period within which to release such life estates free of tax should be extended several years and that the date for decedents dying with pre-1931 life estates retained should be advanced from January 1, 1951, to January 1, 1954. Others have suggested the simpler expedient of reverting to the pre-Church rule, namely that retention of a pre-1931 life estate will not make such property subject to estate tax.

3. Powers of appointment (sec. 811 (f))

Under the amendments made by the Powers of Appointment Act of 1951 (Public Law 58, 82d Cong.), property over which the decedent possessed a general power of appointment is includible in his gross estate. A general power is defined, with certain exceptions, as any power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. Where a general power of appointment was created prior to October 21, 1942, however, the property is includible in the decedent's gross estate only if he exercised such a power. His failure to exercise or his release of such a power does not make the property taxable.

Several taxpayers have suggested that the rule as to pre-1942 powers should be extended to all powers, namely that the property would be taxable only where the decedent had exercised the power. The only exception included in this proposal would be for general powers in connection with property for which a marital deduction had been previously allowed.

4. Proceeds of life insurance (sec. 811 (g))

The proceeds of life-insurance policies on the decedent's life are includible in his gross estate under present law (1) where the proceeds are payable to the decedent's estate and (2) where the proceeds are payable to other beneficiaries if (*a*) the decedent at his death possessed any incidents of ownership in such policies or (*b*) if the decedent paid the premiums on such policies. In the latter case the proceeds are includible in the same proportion that the premiums paid by the decedent bear to the total premiums. However, premiums paid by the decedent prior to January 10, 1941, are not considered provided that the decedent parted with all incidents of ownership in the policy prior to that date.

A number of taxpayers have suggested that the dual tests of (*a*) incidents of ownership and (*b*) payment of premiums is unfair. They state that where a decedent has paid premiums on a life-insurance policy on his life but subsequently divests himself completely of any incidents of ownership of such policy by either assignment or gift, there exists no logical reason to include the insurance proceeds in his estate to the extent of the premiums he paid prior to the transfer. They indicate that the present rule imposes unnecessary obstacles in the use of life insurance in partnership agreements for the purpose of permitting surviving partners to buy out the deceased partner's interest. It has therefore been proposed that the payment of premiums test should be eliminated.

Other taxpayers have suggested a return to the pre-1942 provisions of excluding from the gross estate proceeds of life insurance to a limited extent. Prior to 1942 a $40,000 exclusion was permitted for life-insurance proceeds payable to beneficiaries other than the decedent's estate. The present proposed exclusions vary from $50,000 to $100,000. One taxpayer suggests that insurance proceeds from policies whose aggregate annual premiums have not exceeded $6,000 should be excluded.

5. Joint and survivor annuities

Where an employee under a pension plan established by his employer elects to take a reduced retirement annuity in order to have an annuity payable to his wife or other beneficiary upon his death, the election may be considered a taxable transfer under section 811 so that the value of the survivor benefits are includible in the decedent's gross estate. Where the survivor benefits are held so includible, their basis for income tax purposes is the valuation for estate tax purposes (as provided by the Revenue Act of 1951).

A number of taxpayers have suggested that joint and survivor annuities under approved pension plans should not be subject to either estate or gift taxes. Some have suggested that all joint and survivor annuities be exempt from estate tax.

6. Optional valuation (sec. 811 (j))

Under section 811 (j) an executor may elect at the time he files the estate-tax return to value the decedent's property as of the date of death or as of the date 1 year after death. The election, once made, is irrevocable. Frequently, however, a change in the election may become desirable where adjustments are made by the Commissioner after the return has been filed and the election made. Some taxpayers propose that the election should be available to the executor not only at the time the return is filed but whenever adjustments are subsequently made to the amount includible in the gross estate. Others suggest that the optional valuation should not be an election but that the estate should be given the benefit of the lower value, either value at date of death or 1 year after death.

7. Valuation of unlisted stock (sec. 811 (k))

A number of complaints have been received concerning valuations placed for estate-tax purposes upon the stock of closely held corporations. The code provides that value of unlisted stock shall be determined by taking into account, among other factors, the value of the

stock of listed corporations engaged in the same line of business. In addition, the regulations provide that the valuation to be placed upon closely held stock is its fair market value. Several correspondents indicate that the Bureau insists on using book value as the closest approximation of fair market value for closely held stock. Others write that the Bureau uses a capitalization of earnings method but bases such method only upon the earnings of the most recent and profitable years. The opinion has been expressed that the Bureau should be required to take into account in its valuation the effect of the death of the controlling stockholder upon the corporation's future earnings prospects. In recommending that the valuation should be based upon capitalization of earnings, one taxpayer proposes that the Bureau should be required to take into account a full economic cycle in the corporation's business in order to arrive at a representative figure of average earnings. Another suggests using the ratio of book value to market value of the assets of comparable corporations with listed securities and then discounting the result by 10 percent. Another proponent of the capitalization of earnings method would require that this valuation not exceed book value. Still another taxpayer suggests that the Bureau in valuing the goodwill of a closely held corporation should be restricted to a statutory percentage of the physical assets or book value.

8. Deduction of claims against the estate (sec. 812 (b))

Under present law the deduction for claims against the estate is, in general, restricted to bona fide claims based upon full consideration. An estate may thus not deduct debts, funeral, and administration expenses which it is not legally committed to discharge. One taxpayer suggests that this prohibition works a hardship where the decedent leaves a taxable estate in trust but has exhausted other available resources in a protracted illness prior to death; the beneficiary who then assumes the decedent's funeral expenses and debts receives no deduction for paying these debts. It is proposed that funeral expenses and debts incident to the decedent's last illness should be deductible even though paid out of funds not legally subject to claim or when paid by a member of the decedent's family who is morally obligated to care for the decedent.

Under the present estate-tax law the deductions for expenses, claims, etc., are limited to those allowable under the laws of the jurisdiction under which the estate is being administered. It is pointed out that this operates to exclude expenses incurred in connection with property which is included in the gross estate, but does not form a part of the probate estate. As a result, it has been recommended that the statute be amended to permit the deduction of such expenses.

9. Property previously taxed (sec. 812 (c))

Under present law there is deducted from property subject to the estate tax that which was received by the decedent by gift or bequest, etc., within 5 years of his death, if a gift or estate tax was paid. It is proposed that this period be extended to 10 years.

Under present law, the deduction for property previously taxed is denied with respect to any property received from a prior decedent who was at the time of death the decedent's spouse. Complaint has been made that this is an unnecessary penalty to impose on the estate

of the second decedent merely because the benefits of the marital deduction were available with respect to the estate of the first decedent. As a result, it is suggested that the deduction for property previously taxed should be extended with respect to the estate of a prior spouse.

10. Marital deduction (sec. 812 (e))

Under present law the aggregate marital deduction may not exceed 50 percent of the adjusted gross estate. It has been proposed that the maximum marital deduction should be increased to 100 percent, thus permitting taxpayers to leave their estates to their spouses tax free.

Another aspect of the marital deduction which has been the subject of correspondence from several taxpayers is the deductibility of a widow's allowance. Prior to the Revenue Act of 1950, amounts permitted by State probate law as an allowance from the decedent's estate for the maintenance and support of his surviving spouse or children were deductible under section 812 (b) (5). When the latter section was eliminated by the 1950 act it was stated that the widow's allowance would be deductible under the marital-deduction provisions subject to the limitations therein. One of the limitations of the marital-deduction section is that terminable interests do not qualify for the marital deduction. It has been contended that the terminable interest limitation should not apply to a widow's allowance merely because the amount of the loss may be decreased where the widow dies while the husband's estate is still in process of administration. It has therefore been urged that section 812 (e) should be amended to provide that a widow's allowance should not be considered an interest that can terminate or fail.

Under present law, the marital deduction is not available to the estate of a decedent who is a nonresident alien. This provision is described as having inequitable results where one spouse is a citizen and the other a nonresident alien. If the spouse who is a citizen dies first, the estate qualifies for the marital deduction and, as a result, the surviving spouse, a nonresident alien, receives a relatively greater inheritance than would be true if the nonresident alien died first. This situation is described as, in effect, imposing a penalty upon a surviving citizen and granting a benefit to a surviving nonresident alien. In order to correct this situation, it has been suggested that the marital deduction be allowed to the estate of a nonresident alien where the surviving spouse is a citizen of the United States.

11. Deduction for estate tax paid

Several taxpayers have suggested that the amount required to discharge the estate tax should be deducted from the gross estate. It is indicated that the mechanics of this deduction would be similar to the algebraic formula presently used to compute the charitable deduction where there is a specific bequest with the residue, after estate taxes, going to charity.

A variant of the above proposal is the suggestion that taxpayers be permitted to purchase noninterest-bearing Treasury bonds which would be used to discharge the estate tax and which would not be includible in the decedent's gross estate. Others have suggested that the taxpayer be permitted to designate the Treasury as beneficiary of life insurance which would be excludible from the gross estate. A possible restriction of the above proposals to a maximum limit of $100,000 has also been suggested.

12. Deduction for income taxes paid

Several correspondents have suggested that the amount of income taxes paid by a decedent for a limited period prior to his death, say 3 years, should be deductible from the gross estate. One taxpayer has suggested that all income taxes paid during the decedent's lifetime should be deductible. Another has proposed that any capital gains taxes paid by the decedent in the 5 years prior to his death should be a deduction from the gross estate.

13. Credit for gift taxes (sec. 813 (a))

It has been stated that the present credit allowed against the estate tax for gift taxes previously paid with respect to assets includible in the gross estate does not always serve to place the estate in the same position it would have been if the gift had not been made. For example, if the net estate is substantially less than the gross estate because of a large amount of debts, the full gift-tax credit may not be available. It has therefore been proposed that the combined gift and estate tax on gifts which are included in the gross estate should not be greater than the estate tax which would have been payable if the gift had not been made.

14. Credit for State inheritance, etc., taxes (sec. 813 (b))

A credit is provided under section 813 (b) for any estate, inheritance, legacy, or succession taxes paid to any State up to 80 percent of the basic Federal estate tax. One taxpayer suggests that where State gift taxes are, in effect, a prepayment of State inheritance taxes, such gift taxes should also be allowed as a credit against the basic Federal tax.

15. Credit for charitable gifts

One taxpayer writes that gifts to worthy charities would be greatly encouraged if the code were amended to permit a credit to be taken against the Federal estate taxes up to 80 percent for gifts to approved charities. He indicates that many decedents who are obliged to provide for the maintenance of the surviving members of their families could, under such an amendment, leave charitable bequests designated as a specified percentage of the Federal estate tax.

16. Estate tax exemptions (secs. 812 (a), 935 (c))

Present law provides, in effect, an exemption of $60,000 from the estate tax. Several correspondents have suggested raising the $60,000 exemption to $100,000. On the other hand, one taxpayer has advocated reducing the estate-tax exemption to $10,000. Another taxpayer suggests that an additional exemption be allowed for each surviving child with a further exemption for each year that the child is under 21 years of age. He also suggests that the decedent's estate should receive credit for any unused portion of the lifetime exemption from gift tax.

17. Exemption from estate tax for servicemen (sec. 939)

Under present law the estates of servicemen who were killed in action or who died as a result of line-of-duty injuries or disease during World War II are not subject to the additional estate tax. A similar exemption is extended to the estates of servicemen who are killed in action or who die from injuries or disease suffered in a combat zone in the Korean hostilities.

It has been proposed that the estates of such servicemen should be exempt from the basic estate tax as well as from the additional estate tax. One taxpayer has suggested that the estate tax exemption for servicemen be made a permanent part of the code.

18. Estate tax rates (secs. 810, 935)

A number of general suggestions have been received concerning estate-tax rates. Some correspondents urge that the estate tax should be abolished. Others suggest that estate and gift taxes are properly a function of State governments and should be turned over to the States.

Many have expressed the opinion that the present estate-tax-rate structure is complicated and unwieldy. A single rate schedule has been proposed to supplant the present dual schedules. The proposal would combine the schedules and allow a single specific exemption and a single set of credits. The credit for State death taxes would be retained at present limits but would be expressed as a percentage of the net estate.

Some taxpayers have advocated a closer correlation of income, estate, and gift taxes. One suggestion along these lines would combine the estate and gift taxes, treating gift taxes as advanced payments of the estate tax. Another correspondent suggests that gifts should be treated as either complete or incomplete for the purposes of all three taxes—income, estate, and gift taxes.

19. Miscellaneous

Several taxpayers have proposed that the period for payment of estate taxes should be spread over a period of years, at least 10 being suggested. One proposes that payment in kind with unlisted stocks be authorized.

A number of correspondents have recommended that the code permit an executor to sign a waiver extending the period of assessment of estate taxes as is now permitted for income taxes.

It has also been proposed that the lien imposed by the estate tax, which is a lien for 10 years against the gross estate, should be subject to the same limitations applicable to liens for income taxes and should be required to be recorded in order to be valid against bona-fide purchasers, pledgees, and mortgagees.

One taxpayer has expressed the opinion that the contingent liability of the fiduciary for estate taxes and for unpaid income taxes accrued during the lifetime of the decedent tends to delay the settlement of estates. He suggests that the present provisions which tend to grant relief to fiduciaries in this respect are inadequate. Under present law the fiduciary may file a request for prompt audit and 18 months after receipt of the request by the Bureau the responsibility of the fiduciary is terminated as to returns filed prior to the request for prompt audit. Instead of the present provisions it is proposed that the period for a prompt audit be reduced from 18 to 6 months, with authority given to the taxpayer to execute a waiver extending the period of assessment upon request by the Bureau.

Another taxpayer writes that the provisions of section 607 of the Revenue Act of 1951, applying to decedents dying between March 18, 1937, and February 11, 1939, with retained reversionary interest, did not contain any extension of time for filing refund claims thereunder

so that the substantive relief there provided is denied for lack of a proper remedy. He therefore suggests that refund or credit should be permitted in such cases for a limited period after the enactment of section 607 of the 1951 act.

It has been recommended that the law be specifically amended to provide for the reopening of Tax Court decisions or court decisions to permit a recomputation of estate-tax liability by taking into account the expenses incurred in litigating such liability. It is stated that this matter is partially covered by regulation at the present time but that a specific statutory provision is desirable.

Under present law, the Commissioner is given an additional year to make assessments against transferees for estate- and gift-tax purposes. It has been recommended that the law be amended to limit the Commissioner's right to thus assess liability against transferees during the additional 1 year period only if insolvency prevented the collection of the tax from the primary obligor during the applicable period of limitations.

B. GIFT TAX

1. Gifts of future interest (sec. 1003 (b))

Under present law the gift of a future interest does not qualify under the annual exclusions provision. Section 1003 (b) excludes the first $3,000 of gifts to each donee other than gifts of future interests.

It has been suggested that the limitation on gifts of future interests should be removed. Others have suggested a single exemption of $3,000 for all gifts of future interests in a single year. Still others have suggested that outright gifts to minors should be declared by statute not to represent gifts of future interests whether or not there is a guardian for the recipient minor.

2. Gifts by nonresident aliens

It has been proposed that no gift tax should be imposed on gifts by nonresident aliens solely because the property which is the subject of the gift has a situs in the United States. In support of this proposal it is contended that the present taxation of such gifts has the effect of causing nonresident aliens to remove such property from the United States to Canada prior to making gifts.

3. Tenancy by entirety

It has been recommended that any interest transferred upon the purchase of property as tenants by the entirety should be exempt from gift tax. Under present law, where a husband and wife acquire property as tenants by the entirety, a gift is deemed to be made if one spouse contributes substantially more of the purchase price than does the other. To determine the value of the gift the respective ages of each spouse at the date of gift must be taken into account so that the present worth of the interest transferred can be computed. Similarly, if the property is subject to a mortgage, payments of the mortgage in subsequent years may constitute gifts and require similar computations. Correspondents have indicated that the gift tax in such circumstances is more often honored in the breach than in the observance, usually through nonrealization by the taxpayer that a gift tax is involved. It is contended that since neither the estate tax nor the income tax can now be avoided by acquiring property as tenants by the entirety and

since any gift tax paid is ultimately a credit against the estate tax, imposition of a gift tax represents only an inconvenience to both the taxpayer and the Government and should be eliminated on such transactions.

4. Gift-tax lien

It has been proposed that gift-tax liens should be subject to the same limitations as income-tax liens, namely that the liens should be recorded to be valid against bona fide pledgees and mortgagees.

5. Extension of period of limitations

The taxpayer, it has been suggested, should be permitted to execute a waiver suspending the running of the statute of limitations in connection with gift taxes as is now permitted in the case of income taxes.

6. Adjustment of values after period for assessment

Taxpayers have complained of the practice of the Bureau of adjusting the values placed on gifts as to which the statute of limitations has run. While the Bureau may not assert any additional tax in such cases, it may place a subsequent gift in a higher tax bracket by revising the values reported in the returns for the earlier barred years. It has been suggested that such actions, violative of the principles basic to the statute of limitations, should be precluded by statute.

III. Excise and Sales Taxes

A. ALCOHOLIC BEVERAGES

Most of the suggestions relating to the excise tax on alcoholic beverages suggested a reduction in the tax rate. For example, it has been suggested that the present tax rate of $10.50 per gallon on distilled spirits be reduced to $6 per gallon. Others have taken a more general approach and have suggested that the present tax rate on distilled spirits encourages bootlegging. On the technical side, several correspondents have suggested that the tax-free bond period should be extended from 8 to 12 years. Others have proposed that all package beverages, both alcoholic and nonalcoholic, should be taxed equally and on a strictly volume basis.

B. TOBACCO PRODUCTS

The criticism of the excise taxes on tobacco products has been directed principally toward the rate of tax on cigarettes. One correspondent, for example, has suggested that excise tax rates on such items as tobacco and distilled spirits are much too high relative to the cost of the products before tax. On the other hand, another correspondent suggested that the tax rate on cigarettes should be increased one-half cent per pack because, with the number of cigarette smokers constantly increasing, such a tax increase would not injure the industry. Others have opposed the present flat unit rate on cigarettes and have suggested instead that the tax be based on value or intended retail price. They claim that the present tax is regressive in that it imposes a much higher percentage rate on low price cigarettes than on the so-called standard-priced cigarettes. They believe this is unfair both to the small manufacturers and to the consumers of low-priced cigarettes.

C. RETAIL EXCISE TAXES

The majority of those who have raised objections to the retail excise taxes have opposed the continuation of these taxes, indicating that if repeal cannot be achieved, a substantial reduction in rates should be made. One individual writes that excise taxes can be justified on luxury items only. Another indicates that the taxes on ladies' handbags and on deodorants should be repealed since these are not luxuries. Questions have also been raised with respect to the comparative rates of the various excises. For example, objection was raised to the fact that a 20-percent tax is imposed on a man's wrist watch retailing for more than $65 but only an 11-percent tax is imposed on a fine shotgun and a 10-percent tax on a television set.

It is contended that taxed items are placed at a competitive disadvantage with hundreds of other tax-free consumer items which bid for the customer's dollar. For example, it is indicated, a number of tax-free items directly compete with jewelry which is subject to a 20-percent tax. Among the competing articles are listed oriental rugs, quality furniture, fine bric-a-brac, and expensive wearing apparel.

The repeal of the excise tax on luggage and leather goods was advocated on the basis that the continuance of the tax would seriously injure the industry. Others urged the repeal of the excise tax on furs but indicated that if repeal is impossible, a 20-percent or 10-percent tax should be imposed on dressed skins instead of the present 20-percent retail tax on finished fur garments. An alternative treatment suggested for furs was to reduce the retail tax to 10-percent and exempt the first $400 paid for any fur sold at retail.

An administrative problem was raised in connection with the excise tax on costume jewelry. Retailers have complained that they have no way of determining the value subject to excise tax in the case of articles of costume jewelry affixed to clothing by the manufacturers. The Bureau of Internal Revenue has limited this problem, however, by providing that the tax does not apply in the case of rhinestones, bradis, emblems, etc., which are permanently attached to the garment. Others have expressed dissatisfaction with the fact that cigarette lighters are taxed in some instances at the manufacturers' level, and in other instances, where the lighter is ornamented with precious metals, are taxed at the retail level as jewelry. Retailers have complained that this dual manner of taxing cigarette lighters confuses both their employees and their customers.

An extension of the exemptions from the 20-percent retail excise tax on toilet preparations has also been proposed. Under present law, sales of toilet preparations to beauty parlors and barber shops are exempt from this tax. It is indicated that physicians and hospitals use toilet preparations such as cold cream and massaging ointments in treatment of patients and that the reasons for exempting sales to beauty parlors and barber shops are equally applicable to sales to physicians and hospitals. The proposal would limit the exemption to instances in which these toilet preparations are not resold.

One taxpayer has complained of the inconsistencies of Bureau rulings in connection with excise taxes on certain articles and has cited the following examples:

1. A plastic raincoat case has been ruled nontaxable but shoe bags have been ruled taxable under the luggage tax.

2. Coathangers are ruled taxable under the luggage tax if they are purchased at the same time that a trunk is bought but not if purchased separately.

3. Plastic covers are ruled taxable under the luggage tax if purchased at the same time as a suitcase which they may fit, but tax-exempt if purchased at a different time.

4. Religious articles are ruled taxable under the jewelry tax if worn for personal adornment but not if used for religious purposes.

On the more technical side, it is recommended that legislation be enacted to exclude from the selling price for excise tax purposes all interest and carrying charges, however denominated, normally made on credit sales. At the present time the Bureau excludes from the base of the tax only those finance charges which vary with the length of time credit is extended. It is also suggested that permission be given to those retailers who collect retail excise taxes of less than $10 or $12 a month to file quarterly, instead of monthly, returns. Another suggested that if the excise taxes collected by the retailer amounted to less than $1 per month, no tax should be due. In this connection the Bureau of Internal Revenue has recently announced that, beginning July 1, 1954, such returns may be filed quarterly if the monthly tax involved is under $100.

D. MANUFACTURERS' EXCISE TAXES

As in the case of the retail excises a number of questions were raised in connection with the general level of rates and type of items taxed under the manufacturers' excises. It was suggested, for example, that the taxes on electric light bulbs and electric, gas and oil appliances should be reduced or repealed since these products are necessities, not luxuries. It was also proposed that the 10 percent tax on stoves be repealed on the grounds that the industry was being discriminated against relative to other industries where no tax is imposed. In the case of the 15 percent tax on mechanical pencils and fountain pens, it was stated that the tax is pyramided in such a manner that it represents a 30-percent price increase to the consumer. It was suggested that to overcome this Congress should specify the allowable markups on this tax.

In the case of the tax on gasoline there were suggestions both that the tax be lowered and raised. One correspondent suggested that it be lowered because it was not a luxury. Another suggested that passenger cars were paying their full share of road costs through the present gasoline taxes and that until the States raise a fair proportion of their road funds from trucks, the Federal Government should raise any additional road funds from a graduated tax on truck tires or from tolls collected according to weight. On the other hand, one correspondent suggested that the tax on gasoline be increased 1 cent a gallon because the present tax on gasoline was small relative to that on distilled spirits. Another suggested that in order to aid the traffic problem the tax on gasoline be increased, and that on public transportation of persons should be decreased.

A large portion of the problems presented on manufacturers' excise taxes were concerned with the operation of the special exemptions and

crediting devices where two or more excises are involved. It was suggested that the diplomatic exemption, if it is to be available at all, should not be limited to purchases from manufacturers. It is stated that embarrassment and ill will are created because diplomatic representatives of foreign governments are unaware that the exemption applies only when the article purchased is acquired directly from the manufacturer. Another suggestion was that the filing of exemption certificates should not be required in the case of exempt sales to governmental units where bona fide orders are signed by Government officials. Objections were also raised to the mechanics of the exemption for sales abroad. At present in order to obtain the exemption the manufacturer must ship the product abroad or, if purchased by a domestic taxpayer, he must submit a sworn statement that he is purchasing for export or for sale to an exporter. It has been suggested that refunds of tax should be provided in the case of domestic dealers exporting products on which a manufacturers' excise has been paid even though the dealer did not anticipate the sale at the time of his purchase. The taxes on lubricating oil and gasoline were the products specifically mentioned in connection with this problem. Objections were also raised to the fact that in the case of the exemptions for sales for "further manufacture," for export and for use as supplies for vessels of war only the original manufacturer is eligible for a refund. It was also suggested that the tax crediting procedure for the excise tax on tires and tubes placed on new cars, and therefore a part of the base for the automobile tax, was too cumbersome. To overcome the need for this complicated type of credit it was suggested that the tax on tires and tubes be changed to an ad valorem tax, at the same rate as that on automobiles. A similar suggestion was made with respect to automotive radios. The need for a credit for the tax on lubricating oils where such oil is placed in a new car sold by a manufacturer was also suggested.

The restrictions placed on refunds of overpayments of excise taxes represents another problem with which manufacturers are concerned. In order to obtain a refund or credit, the manufacturer must establish (1) that the tax was not included in the price of the articles sold, or (2) that the amount of the tax was repaid to the ultimate purchaser or that the ultimate purchaser's written consent to the refund has been obtained. It is contended that these conditions for obtaining a refund impose an almost impossible burden of proof upon the manufacturer and tend to encourage nonpayment of disputed taxes.

The determination of the tax base for the manufacturers' excises is another area of dissatisfaction. For example, dissatisfaction has been expressed with the present provision which provides that where a manufacturer rents instead of sells an article, the rental is considered the sale of the article for purposes of the manufacturers' excise taxes. It is indicated that basing the tax upon the total rental charge frequently results in articles being taxed at amounts in excess of their fair market value. Some have suggested that rentals and leases be removed from the bases of the manufacturers' excises; others recommended basing the excise tax on the fair market value of the article in such cases; and still others suggested that where a rented item (previously unsold) is sold, a credit be allowed for the excise tax previously paid

on the rentals. The products mentioned in connection with this problem were business and store machines, and automotive trailers.

The determination of the tax base where the manufacturer sells directly to retailers has also presented a problem. Where the manufacturer sells at retail, present law provides a procedure for determination of the manufacturer's price. However, if the manufacturer acts as his own distributor and sells to retailers there is no similar procedure for fixing a fair manufacturer's price. It is contended that, in such a situation the manufacturer is at a competitive disadvantage since the tax base of competitors is on the manufacturing price, while his base is the distributor's price. It has been proposed that the procedure for the determination of a fair manufacturer's price by the Commissioner should be extended to sales by manufacturers acting as their own distributors.

Certain of the manufacturers taxes also provide for the taxing of parts or accessories sold on or in connection with taxable articles. It is said that it frequently is difficult to determine whether accessories are sold in connection with the taxable article and that a difficult competitive situation is created where the accessory is nontaxable if sold separately by a manufacturer of the accessory only. It has been suggested that the purpose of taxing parts and accessories—namely, to prevent the sale of a taxable article in a knockdown condition—can be more effectively accomplished in a manner that would not create unfair competitive situations. This problem was raised in connection with the tax on cameras.

A number of tax base problems relating to specific excise taxes also have been raised. Several of these relate to the excise tax on automotive parts and accessories. It was suggested, for example, that no excise tax should be imposed on parts and accessories sold for farm equipment. The Revenue Act of 1951 removed the tax on parts and accessories used or resold for the repair or replacement of farm equipment parts, and prior administrative rulings had held that parts and accessories sold to manufacturers for use on new farm equipment were not subject to tax. However, spark plugs, storage batteries, leaf springs, coils, timers, and tire chains represent exceptions both to the administrative and legislative actions, since they are presently subject to tax even though purchased for farm equipment. Moreover, in the case of manufacturers of farm equipment, if they buy from distributors, instead of manufacturers, of the parts and accessories the tax is presently held to apply.

Objections also have been raised to the manner in which the tax on automotive parts and accessories is applied to sheet glass installed in trucks and cars. At the present time glass which is cut to the exact size required by automobiles and sold to someone else to install is considered an automotive part or accessory and is subject to tax. On the other hand, if the one who cuts the glass to fit a car also installs it no tax is due since this is considered to be the use of nontaxable glass for the repair of a car, and charges for repairing are not subject to tax. It is pointed out that the effect of the present treatment is to impose the tax where the car owner installs a window glass cut to fit by a repair shop, while no tax is due if the car owner pays the repair shop to install the window glass. It is suggested that in order to remove the discrimination against the former method of doing business, no

tax should be applied in either case. A further suggestion with respect to the excise tax on automotive parts and accessories was that the tax on rebuilt parts be repealed. The arguments presented for this action were that the tax is hard to administer and brings in little revenue.

In the case of the tax on sporting goods objections were raised to the continued inclusion in the tax base of croquet balls and mallets and table tennis balls, while baseballs and footballs are excluded on the grounds that they are used by schoolchildren. It was also recommended that children's skis be exempt from the tax.

The suggestion was made that television owners be required to pay a use tax in the amount of $12 per year. Canada once imposed a use tax of $2.50 per year on radios but has since repealed this provision.

E. MISCELLANEOUS TAXES

A number of suggestions have been received to repeal both transportation taxes. Others have proposed elimination of only the tax on the transportation of property. If repeal of the tax on the transportation of persons is impossible, it was suggested that the present exemption for fares not exceeding 35 cents be increased to an exemption for fares not exceeding $1. This proposal apparently is directed toward the elimination of taxes on commutation fares. Elimination of the excise tax on railroad seating and sleeping accommodations has also been proposed on the grounds that these accommodations are similar to those provided by a hotel for its patrons. On the other hand, objections have been raised to the exemption for vehicles with a seating capacity of less than 10 passengers, an exemption which is available only when the vehicles are not operated on established lines. It is stated that this exemption has resulted in a large increase of for-hire transportation of passengers by unregulated and untaxed motor carriers.

In connection with the tax on transportation of oil by pipeline one correspondent suggests that the cost of movements of oil from a tank farm to a refinery should not be subjected to the excise tax on transportation of oil by pipeline. The correspondent contends that the lines of pipe running between the refinery and its tank farm are merely refinery auxiliaries rather than "transportation" within the intent of Congress, and that the necessity, in some cases, of separating the refinery proper and its tank farm does not justify imposition of an excise tax.

A number of suggestions have also been received that the excise taxes on telephone, telegraph, and radio messages be repealed. It has been stated in support of repeal of the excise tax on local telephone service that it is the only local utility subject to tax. Another argument advanced for the repeal of the communication taxes is that these taxes increase for the consumer the size of any rate increases which the company must obtain in local regulatory proceedings. At a more technical level it has been proposed that fire-alarm systems be excluded from the 8-percent tax on wire and equipment service. It has also been proposed that all public utilities should be included in the category of industries exempt from the 25-percent tax on leased mobile radio equipment when such equipment is utilized in the conduct of their business.

Under present law exemptions from this tax are limited to leased mobile equipment used by common carriers, telephone or telegraph companies, or radio broadcasting stations or networks using such equipment in the conduct of their business.

The suggestions under the admissions tax have been directed largely toward the exemptions provided. An exception to this is a proposal that the entire tax be repealed on the grounds that such action is necessary for the survival of the motion-picture industry. The exemptions from the admissions tax with respect to which problems were raised are as follows:

(1) It was stated that the exemptions from the admissions tax appeared defective because hospitals for crippled children are exempt while equally worthy institutions are taxable. It was pointed out that medical science and the Government recognize the existence of several kinds of disabilities, and that a President's committee is helping some 20 associations for the disabled. It was suggested that a list of all associations for the disabled be obtained and that all of them be granted exemptions from the admissions tax. Under present law admissions to any athletic game or exhibition between two elementary or secondary schools are exempt from tax if the gross proceeds inure to the benefit of a hospital for crippled children. With this exception, admissions, where the benefit inures to hospitals for crippled children, are taxable unless the hospital qualifies under the general definition of a charitable organization for admissions tax purposes. In order to so qualify, the hospital, or any other charitable organization, must be supported in whole or in part by funds contributed by a governmental unit, or primarily supported by contributions from the general public.

(2) Admissions to swimming pools, bathing beaches, skating rinks, and other places providing facilities for physical exercise operated by a governmental unit are exempted from the admissions tax. Admissions to similar privately operated facilities, however, are subject to this tax. One correspondent indicated that the repeal of the tax on admissions to private swimming pools was essential to the continued operation of such pools by private individuals. Another suggested also that all admissions to facilities which would be exempt if operated by a governmental unit should also be exempt where such facilities are operated privately.

(3) The exemptions under the admissions tax were provided by the Revenue Act of 1951. In the House version of this bill, admissions where the proceeds inured exclusively to the benefit of educational organizations were exempted from tax. In the bill as finally enacted, however, admissions where the profits inured to an educational institution were excluded from this tax only if such organization normally maintained a regular faculty and curriculum and normally had a regular organized body of pupils or students in attendance at the place where its educational activities are regularly carried on. This limitation on the exemption in the case of educational organizations had the effect of denying an exemption from the admissions tax in the case of many organizations which were classified as educational, although not operated

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as regular schools or colleges. One correspondent recommended that the House version of this exemption be reinstated so that ballet performances would be exempt from the admissions tax.

(4) Admission to high-school athletic events are excluded from the application of the tax except in the case of boxing and wrestling matches. It was suggested that admissions charged by high schools also should be exempt in the case of these sports. Exemption from the admissions tax on admissions to sports activities of junior colleges was also suggested, as well as admissions to American Legion junior baseball games.

(5) Admissions to historic sites, houses and shrines and museums operated by a society devoted to the maintenance of such sites, etc., are excluded from the application of the admissions tax if no part of the net earnings inures to the benefit of any private stockholder or individual. It was stated that this provision does not provide any exemption for public museums such as art museums, museums of natural science, etc. Bureau of Internal Revenue rulings have indicated that this exemption is available in the case of public institutions, but only if the historic site, museum, etc., is maintained and operated by an organization principally devoted to the preservation and maintenance of such an institution. The fact that many public museums, etc., are not operated by separate and distinct commissions makes it impossible for them to qualify for this exemption under present law. Moreover, they do not qualify as educational institutions for purposes of the admissions tax because, as pointed out above, an educational institution, in order to be exempt from the admissions tax, must maintain a regular faculty curriculum, etc. It has been proposed that admissions to historic sites, houses, shrines, museums and parks operated by any State or political subdivision thereof or by the United States or any agency thereof be exempt from the admissions tax.

It was also suggested that the law be clarified with respect to whether or not carnival rides are subject to the admissions tax.

A problem was also raised with respect to the excise tax on club dues and initiation fees. In the case of an overpayment of tax, the Bureau of Internal Revenue has held that the club members are the taxpayers and that if the club files the claim for refund, it must also submit a power of attorney with respect to each of its club members for whom a refund is being requested. It has been suggested that this is unnecessarily burdensome to the taxpayers.

The stamp taxes, especially the stamp taxes on corporate securities, have been singled out by a number of correspondents. Many taxpayers have complained that the state of the law regarding liability for stamp taxes on certain corporate securities is unsettled and needs clarification. They indicate that for many years liability for stamp taxes was not deemed to attach to corporate notes unless such notes were in registered form or had interest coupons attached. In the *General Motors Acceptance Corporation* case (161 F. 2d 593; certiorari denied, 332 U. S. 810), however, this established rule was overturned and the term "debenture" was held to include certain corporate notes not in registered form and without interest coupons attached. Subsequent decisions and Bureau rulings, it is contended, have further confused the

question of whether a particular instrument would be classified as a debenture subject to stamp tax or as a simple note not subject to tax. It has therefore been proposed that all evidences of corporate indebtedness which do not have interest coupons attached or which are not in registered form should be exempted from stamp tax.

Another suggestion was that the stamp tax should be imposed only once on convertible debentures, instead of both at the time of original issuance of the debentures and at the time when such debentures are converted into stock. Along somewhat similar lines is the suggestion that the law should be clarified to indicate whether or not stamp taxes are due on an increase in the stated value of capital stock when no additional shares are issued. Other correspondents have suggested that in the tax rates on stock transfers the differentiations made between par value stock and no par value stock have no economic justification. Instead, it was proposed that the rates on transfers should be based on the selling price in all cases.

It has been recommended that section 1802 (b) be amended to make clear that there is no taxable stock transfer where, pursuant to statutory merger or consolidation, stock of the continuing or resulting corporation is issued directly to the stockholders of the merged or constituent companies. The application of a tax in such a situation has been upheld in *American Processing & Sales Company*, 164 F. 2d 918 (7th Cir. 1947), *United States Industrial Chemicals, Inc.* v. *Johnson*, 181 F. 2d 413 (2d Cir. 1950) and in *Western Mass. Electric Company* v. *United States*, 101 F. Supp. 544 (D. C. Mass. 1951).

The code exempts from the stock-transfer tax mere loans of stock. Prior to that amendment, the code provided for an exemption in the case of the return of stock to the lender. No similar exemption covering the mere loan of bonds and the return of bonds loaned is provided in section 3481. Therefore, it has been recommended that in the interest of uniformity a similar exemption be provided with respect to bonds.

It has been pointed out that certain religious organizations have created investment trusts in order to permit broader diversification and qualified supervision of investments at low cost for small churches and charities. It has been suggested that the shares issued by such trusts be exempted from stamp tax.

In connection with the Federal taxes imposed on coin-operated gaming and amusement devices, it has been proposed that the present $10 per year tax on the operation of any amusement or music machine operated by coin, etc., should be increased to $200 and that the so-called slot machine tax, now $250 a year, should be increased to $1,000 a year. On the other hand, objection has been raised to imposing the full $250 tax on slot machines operated at summer resorts since these resorts are usually in operation less than half the year. It has been suggested that the tax in such instances should be prorated for the period in which the machine can be operated, especially where State law prescribes the permissible period of operation. Others have objected to the practice of the Bureau of classifying as slot machines any pinball or similar machine on which prizes of cash or merchandise are paid.

The present wagering taxes apply to punchboards and similar operations. As a result, a 10-percent tax is imposed on the value of all

punches, and the proprietor of an establishment containing punchboards must pay a $50 occupational tax. Complaint has been made that the imposition of the wagering taxes in this area (especially the occupational tax as applied to small retailers) has practically destroyed the industry of manufacturing punchboards and at the same time has been productive of very little revenue. It has been suggested that punchboards be removed from the scope of the tax, or, alternatively, that the tax be converted to a manufacturers' excise in the nature of a stamp tax.

The following suggestions have been made with respect to other miscellaneous taxes:

(1) The 20-percent tax on leases of safe-deposit boxes should be repealed.

(2) The tax on bowling alleys, billiard and pool tables should be increased from $20 to $200 per year.

(3) No stamp tax should be imposed on an insurance policy covering infantile paralysis written by Lloyds of London when no similar tax is imposed on policies written by domestic insurance companies.

(4) The wagering tax should be repealed.

F. GENERAL EXCISE TAX SUGGESTIONS

Two new excises have been proposed:

(1) A graduated use tax on boats with rates ranging from $200 on boats just over 28 feet in length to a maximum rate of $750 on those over 200 feet in length.

(2) A use tax on automobiles and trucks with the following tax schedule:

(*a*) Automobiles, seven passengers or less: $20.

(*b*) Buses or automobile buses: $150.

(*c*) Automobile trucks of 1 ton or less: $50.

(*d*) Automobile trucks in excess of 1 ton and not over 4 tons: $100.

(*e*) Automobile trucks in excess of 4 tons: $150.

(*f*) Truck trailers, semitrailers, and tractors: $300.

A number of more general suggestions have also been received. Some taxpayers advocate that the Tax Court should be given jurisdiction of excise tax litigation. Others have recommended that when a refund is made pursuant to a final order of a regulatory authority, the amount of excise tax involved together with any interest thereon so refunded may be taken as a credit without regard to any statutory limitation. Others have proposed that small businesses whose excise tax obligations amount to $5 or less per month should be relieved of paying such taxes. On a broad policy approach, it has been suggested that Federal and State Governments should not overlap in the imposition of excise taxes. Along the same lines, it has been proposed that considerable duplication of tax-collecting expense could be eliminated by a closer coordination of Federal and State tax administration.

G. SALES TAX

A number of correspondents have expressed the belief that a Federal sales tax should be enacted. The viewpoint generally taken is that a

broad-based tax, such as a sales tax, should be imposed to permit reduction in the present individual and corporate income tax rates and to permit elimination of most of the present excise taxes. It is stated that the present system of selective excises is frequently discriminatory as between related products and services. Some take the position that enactment of a Federal sales tax could be the occasion for alleviating the progressive features of the income tax and for redistributing the tax burden. The correspondence which dealt with the sales tax was not uniformly in favor of such a tax. Some taxpayers expressed opposition to the idea of a sales tax on the ground that such a tax would be inequitable and would have questionable economic consequences.

On the form a sales tax should take the proponents were far from uniform in their suggestions. The principal area of disagreement lay in whether the tax should be imposed at the retail or manufacturers' level. Also, some proposals included exemption for particular categories of consumer items whereas other proposals suggested the use of certain levels of personal exemptions.

The more typical of the various sales tax proposals are the following:

(1) A broad-based manufacturers' excise tax should be enacted that would exempt only items of food, shelter, and medicine.

(2) A Federal sales tax should be imposed at the retail level utilizing, where possible, the State machinery already set up to collect sales taxes. (A variant of this proposal would impose a Federal retail sales tax of between 10 and 25 percent with no exemptions, adding thereto a State sales tax to cover State expenses and providing for collection by the States.)

(3) A general sales tax should be imposed with the following personal exemptions:

> (*a*) Single person with income of less than $1,000—an exemption of $500.
>
> (*b*) Married couple with income of less than $2,000—an exemption of $1,000.
>
> (*c*) An exemption of $500 for each child or other dependent and an additional $500 exemption for the blind or for persons over 65 years of age.

Taxpayers claiming the above exemptions would have to file a claim for refund at the end of the year.

(4) The entire system of excise taxes should be repealed and replaced with one of the following:

> (*a*) A tax of 1 percent of the manufacturers' sales price on all manufactured items.
>
> (*b*) A tax of 1 percent on the charges for personal services.
>
> (*c*) A 25 percent duty on all incoming foreign merchandise.

(5) All individual income taxes should be removed on incomes under $6,000 and in lieu thereof a Federal sales tax should be imposed at the consumer level.

Some correspondents have advocated a transactions tax. One form of a transaction tax suggested was a tax on business gross income. This was advocated on the grounds that everyone, including insurance and investment companies, would then bear part of the tax burden.

IV. Administration, Procedure and Accounting Problems

A. THE BUREAU OF INTERNAL REVENUE AND THE TAXPAYERS

1. *Information*

Several suggestions were to the effect that the Bureau of Internal Revenue should, in one way or another, make more information available to the public so that returns would be more nearly correct. One suggestion is that the Bureau should publish a series of question-and-answer booklets, organized as to subject matter and indexed in detail. Another is that each instruction booklet supplied with individual income tax return forms should contain a list of changes made by legislation or court decisions during the year.

Several suggested that better working relationships should be established between the Bureau and groups of accountants and businessmen; suggestions were made that persons qualified as accountants and tax specialists should meet with groups of businessmen and associations, or even visit local business establishments to discuss tax problems and to explain the necessity and advantages of good records.

It was stated that deputy collectors were unable or unwilling to answer any but the simplest questions in connection with the preparation of returns, and that if an unusual situation were presented conflicting answers were likely to be received.

2. *Forms*

Several suggestions intended to improve the use of various forms issued by the Bureau of Internal Revenue were received:

Several complaints related to the inadequate distribution and availability of income-tax forms—1040 and supplementary blanks. It was stated that farmers rarely received the necessary form 1040F with their forms 1040; that frequently the information booklet did not accompany the return form; that requests of accountants and attorneys for forms were complied with inadequately or only after long delays. It was suggested that supplies of the personal income-tax forms be made available at all post offices.

One correspondent states that when an error is made in the original return requiring payment of an additional tax, the only method now permitted is the filing of an amended return with all details supplied as with the original return. He suggests a form similar to the claim form 843, permitting merely a statement of the error and a recomputation of the tax.

A correspondent suggests that, because many persons claim as dependents persons whom they do not actually support, the return form should be accompanied by a dependency form requiring specific and detailed data as to the amounts spent by the taxpayer, and for what purpose, with respect to the dependent.

One correspondent referred to the present requirement that amounts withheld under the Federal Insurance Contributions Act must be reported quarterly for each employee on schedule A of form 941, and that the total amount for each employee withheld during the year must be reported, with income tax withheld, on form W–2 issued to each employee. He suggests the elimination of the quarterly reports as to each employee and the revision of forms W–2 to show amounts paid each quarter and the total.

The suggestion was made that any officer elected by the board of directors be allowed to sign the corporate return.

3. Bureau rulings

There is considerable criticism of the use by field officers of unpublished rulings:

The Bureau's position is often determined by unpublished rulings and the fact that the ruling is not cited in support thereof merely makes harder the taxpayer's task of determining whether the position taken is sound. Not only should they not be cited in support of a position—they should not even be furnished to Bureau representatives in the field.

It is suggested that all rulings of any interest to taxpayers be published in the Internal Revenue Bulletins.[1]

It is stated that the Bureau should be bound by all rulings, even those given by field agents in response to specific inquiries.

Local office rulings should be backed up, or not given in any form—even as advice.

It is stated that there is a great need for the elimination of tax risks resulting from unforeseen tax consequences of a transaction otherwise desirable.

No tax result can be as bad as an uncertain result. Known dangers can be avoided. Business units should not be put at their peril to guess future administrative policy or court decisions.

It is suggested that the Bureau modify its present policy of not giving rulings on prospective transactions (except with respect to a few classes of transactions) and should give rulings in advance of transactions in most cases. It is suggested that such prospective rulings could be made by a board analogous to the Tax Court, with the Bureau to be required to acquiesce (and thereafter be bound) or nonacquiesce in this board's decisions.

One correspondent referred to the long delay of 14 months in obtaining a ruling from the Bureau which affected many taxpayers.

When a ruling is requested by the taxpayer it should not, according to a number of correspondents, be made retroactive.

4. Regulations

Several correspondents deplored the long delays (sometimes over a year) that have occurred in many cases between a change in the law and the issuance of related regulations. It is pointed out that contemplated transactions sometimes cannot safely be completed until doubtful questions of interpretation are resolved by the issuance of regulations. One correspondent attributes much of the delay to "the slipshod hazy language of many of our tax law provisions."

One correspondent finds many parts of the regulations obscure, primarily because of the "extremely long sentences" which are used.

Numerous correspondents stated that in many cases the regulations do not conform to the intent of Congress. Most of these correspondents suggested that no section of the regulations should be promulgated until it had been approved by the Joint Committee on Internal Revenue Taxation, by some committee of Congress, or by "Congress." One suggestion is that all regulations be "written" by the staff of the joint committee. Other suggestions were that all regulations and

[1] The Bureau has recently announced its intention of publishing practically all of its rulings.

rulings be checked or reviewed periodically by technicians who should report to Congress any instances of violation of congressional intent.

5. Examinations

There were several complaints that examinations by revenue agents were neither started nor completed promptly. It is contended that agents should be required to finish examinations which have been started. One reference was to questions asked, followed by 4 months during which there was no progress. Another reference was to two examinations started last winter with no action between then and September.

There were several suggestions that 2 or 3 years, or all years including the last return filed, should be examined at one time.

It was stated that honest taxpayers should not have their returns audited year after year; emphasis should be placed on careful audits of businesses which can conveniently absorb nonbusiness, personal expenses, such as contracting, retailing, service stations, restaurants.

It was argued that much time is wasted by making adjustments shifting minor items from one year to another, with little net change in tax liability for the years involved.

Many correspondents complained of an ultratechnical insistence on small adjustments, apparently made for the sake of a better efficiency rating for the examining officer on the basis of an increased tax liability. It was pointed out that documentary proof could hardly be produced for many deductions such as church contributions, gasoline taxes, meals, etc., yet examining officers were disallowing deductions on the basis of failure of proof. It was argued that if the underlying circumstances indicated that expenditures were necessary reasonable allowances for such deductions should be acceptable.

It was stated that office auditors frequently require taxpayers to appear with all their books and records, thus producing much annoyance and expenditure of time, when a simple request for the explanation of one or two doubtful items would be sufficient.

There were complaints that a small minority of examining officers made unwarranted adjustments merely because they were antagonistic toward taxpayers with large income. One is said to have disallowed officers' salaries as excessive merely because "they had no more right to drive Cadillacs than I have." On the other hand, one attorney stated that it has been years since he has had dealings with any examining officer with a "chip on his shoulder," although they are strict when such an attitude is justified.

There were many complaints that in many cases adjustments made by examining officers could not be corrected, even though apparently unwarranted, because the cost of preparing protests, employing attorneys or accountants to appear at conferences, etc., was greater than the asserted deficiency.

One correspondent urged that the system in the Bureau "whereby agents are graded on the number of cases worked and dollars of tax produced" should be eliminated.

A correspondent urged that agents be required to submit a certificate with their report of examination to the effect that the taxpayer has been afforded—

> the benefit of all credits, deductions, and other benefits allowable to him under the provisions of the Internal Revenue Code—

to insure an objective determination of the true tax liability.

Criticism of the inadequacy of agents' reports of the results of examinations were made. It was stated that sufficient explanation, in nontechnical language, with reference to pertinent provisions of the law and regulations, was not given, so that frequently taxpayers could not refute the agent's conclusions without calling in experts at considerable expense. It was also urged that "confidential" portions of reports, not available to taxpayers, be prohibited, since such "confidential" items tended to bias a conferee against the taxpayer, with no opportunity for refutation.

6. Waivers extending the period for assessment

Many correspondents objected to what they called the practice of the Bureau of not examining returns until near the end of the 3-year period of assessment and then, with what amounts to coercion, obtaining waivers permitting assessment during subsequent years. It was stated that long delays (often from 5 to 7 years or more) in determining tax liabilities produced financial hazards for the taxpayers and made for gross inefficiency since errors that should have been found promptly were repeated on subsequent tax returns. One correspondent said the evils were so great that the Bureau should at once become current in its operations, even if returns for several years for many taxpayers had to go unaudited. Another said that all examinations should be made within a year or 18 months.

Many persons stated that no extension beyond the 3-year period should be permitted, although one person conceded that a waiver should be permitted where both the taxpayer and the Government believed an extension would be beneficial. Others stated that waivers should be permitted where both the taxpayer and the Government agree but should not be permitted beyond 5 or 6 years from the date the return was filed.

7. Taxpayers' representatives

A flood of correspondence was received pertaining to the qualifications which should be required for persons who prepare returns and represent taxpayers during examinations and in subsequent proceedings. As might be expected, there was a great diversity of viewpoint and emphasis between "public" accountants and C. P. A's, between accountants and lawyers, and between those primarily concerned with the problems of "small" taxpayers and those interested in larger problems.

Several correspondents deplored the activities of "curbstone tax experts," those who, with little accounting or legal knowledge, prepare the returns of "small" taxpayers for fees often disproportionate to the real value of their services. Various suggestions were made: that only consultants "registered" and somehow approved by the Treasury Department be permitted to prepare returns for others; that such persons should be "regulated"; that the law should require a legal or accounting background for such persons; that such persons should be "licensed" and required to attend schools of instruction established or supervised by the Bureau of Internal Revenue; that penalties be provided for the preparation of a return by anyone not holding a Treasury tax practitioner's enrollment card. One correspondent, pointing out that certified accountants and members of the bar

are bound by the ethical standards of their professions, suggested that Treasury regulations require every person who prepares another's return to state his sources of information and the extent of his verification of the accuracy of the data.

Many correspondents opposed any law or regulation which would prohibit competent and experienced "public", but not certified accountants from assisting "small" taxpayers not only in preparing their returns but in conjunction with agent's examinations and conferences. It was contended that many such persons are competent to handle all the ordinary tax problems of small-business enterprises, professional men, and small-scale investors; that, particularly in small towns and areas not adjacent to large cities there were not certified accountants and tax attorneys available for this work; and to exclude them would greatly expand compliance and administrative problems. Various criteria were suggested to weed out the unfit; the possession of a State license in those States which license noncertified accountants; proof of having practiced their profession for various numbers of years; certification by local Treasury officials who had knowledge of their ability, etc. There were many suggestions to the effect that the Treasury Department should establish a secondary type of "enrolled to practice" card, available to those who are not certified accountants or attorneys and who may not be able to pass the present type of examination required for enrollment, but who can give evidence of accounting and tax practice, ability, and character. Such a card would permit the holder to represent "small" taxpayers with ordinary problems at the local level, up to the conference with the Appellate Division. Pointing out that the present examination required for the enrollment of one who is not a certified accountant or member of the bar is as difficult as a part of the examination given for candidates for accountancy certificates, it is suggested that the Treasury Department use a less difficult and comprehensive examination.

Several correspondents suggest that the taxpayer should have the right to be represented by any person of his choice, whether or not he was an attorney or a certified public accountant, so long as the Treasury Department had not removed him from its rolls for cause.

One correspondent deplored the fact that although he had been employed for over 6 years as a deputy collector, internal revenue agent, conferee, and instructor of revenue agents, he is denied an "enrolled to practice" card unless he takes the examination.

One accountant believes it is "essential to the protection of the taxpaying public" that communications between the taxpayer and his accountant and knowledge of his client's affairs obtained by an accountant should be "privileged" and not permitted to be divulged to examining officers without his client's consent as in the case of lawyers.

Two correspondents believe that no one other than a person duly enrolled to practice with the Treasury Department should be permitted to represent taxpayers in informal or formal conferences or other proceedings; one advocated that any representation by one not so enrolled should be deemed a felony and that the Treasury agent permitting it should be discharged.

8. Appeals within the Bureau of Internal Revenue

One correspondent contended that since field agents often spent months in making their examinations, the taxpayer and his representatives should have a longer period than 30 days in which to prepare the protest.

There were several complaints that the conference arrangements under the recent Bureau reorganization do not provide a disinterested consideration of the taxpayer's protest. The arrangement is for an informal conference with the examining officer's group chief, then a formal conference before a member of the Appellate Division. It is argued that the agent will have discussed the problems with his group chief during the course of his examination, so that the group chief is prejudiced in favor of the agent's viewpoint when he comes to the conference. Then, instead of the second conferee being a part of an organization separated from the local office, as was the old Technical Staff, the conferee now is responsible to the local Director or the District Commissioner, and may therefore be supposed to share the viewpoints and prejudices of that district. It is also objected that formerly the taxpayer could have a formal conference with the agent conferee and then after the 90-day letter was issued, work with the Appellate Division to settle the case without trial; whereas now, since the only formal conference is with a member of the Appellate Division, when any effort to settle the case before trial is made the same Appelate Division as conducted the previous conference must be dealt with.

Some complaints were received that conferees were seldom willing to concede all the issues, but insisted on a small deficiency. This was referred to as "legal blackmail," because it is possible only because the taxpayer cannot afford to litigate a small deficiency.

One suggestion is that in all cases involving a deficiency or claim of more than $5,000, two conferees, and not one, should decide the issues.

Another suggestion is that if the conferee's decision is changed after review of his conclusions, the taxpayer should be granted a conference with the reviewers.

One correspondent objected to settlements of pension trust questions by local conferees, because he maintained that there are different views on pension trusts—a very complex subject—among the different localities. He suggested that specially trained men should go from Washington to the various local divisions and act as conferees on pension trust questions.

Several correspondents complained that there is no provision for appeals within the Bureau, as there is with respect to income taxes and estate and gift taxes, where deficiencies of excise taxes, withholding taxes, etc., are asserted. Since there is no chance for settlement out of court, the only recourse being payment of the tax and a suit for refund, questionable deficiencies of $1,000 or less are usually paid because the cost of litigation is too great.

9. Refunds

There were several complaints about the delays in paying refunds. It is stated that in some cases more than 2 years has elapsed from the time the examining agent determined a refund was due to the receipt

of the check. It is stated that much delay is occasioned by referring refunds to Washington, and that refunds should be determined and paid by the District Commissioner in each case.

One correspondent states that there are long delays in actually making refunds after a court has finally determined that a refund is due. It is suggested that no judgment refund claim and no Bureau proceedings are necessary, but that refunds should be made immediately after judicial determination.

It is suggested that where the taxpayer has filed a claim at a time when a deficiency in another tax or another year is asserted collection of the deficiency should be deferred until the claim is acted upon.

B. THE TAXPAYERS AND THE COURTS

1. Cost of litigation

A great many persons deplored the fact that in many cases alleged deficiencies believed to be unjust and likely to be eliminated if an appeal were taken to the Tax Court or a district court were nevertheless paid because the cost of litigation would be greater than, or disproportionate to, the amount involved. Many blamed Bureau personnel for overzealousness, carelessness, etc., and some used words like "tyranny" and "legalized blackmail" to describe these situations. Others conceded that if there was a doubt the Bureau agents should resolve the doubt in favor of the Government pending judicial determination of the question, but they nevertheless deplored the resulting hardships on many taxpayers.

Some correspondents could find no remedy for this situation. Others suggested vague "penalties" for the personnel involved, or for the Government generally. Some suggested payment by the Government to the taxpayer of varying portions of the tax involved, a large portion of a small deficiency, a smaller portion of a large deficiency, with a maximum, where the Government lost in litigation.

Most correspondents suggested that (as in many civil suits) if the Government lost in litigation, the costs of litigation—court fees and lawyers' fees—be paid to the taxpayer if the case were decided in his favor. One or two suggested additional payments to reimburse the taxpayer for time lost by him or by his employees. Two suggested that the party which lost in litigation pay the costs, the taxpayer to pay an estimated cost incurred by the Government if the decision were for the Government. Payment of litigation costs when the Government lost was deemed desirable (1) to produce equity with respect to the taxpayer litigants; (2) as an effective deterrent to the assertion of deficiencies in cases where the facts or the law had not been sufficiently explored, or where there was substantial doubt as to the legal point; and (3) as tending to produce quicker settlement of legal questions in areas where the amounts involved were likely to be small.

2. A special court for small cases

Some correspondents, deploring the fact that many asserted deficiencies believed to be unjust must nevertheless be paid because the cost of litigation under present procedures would be too great, advocated some new type of procedure for small cases.

Some correspondents advocated passage of H. R. 1062, 82d Congress, or similar legislation, which would provide a Tax Settlement Board of 25 members to resolve disputes informally, without elaborate procedures or rules of evidence.

Others advocated some type of "small-claims court" less elaborate that the court envisaged in H. R. 1062. It was suggested, for example, that in each locality groups of 3 or 5 persons, consisting of a Treasury representative, a practicing tax attorney or accountant, or both, and one or two reputable businessmen be set up, to decide tax controversies involving not more than $500 or $1,000, with the taxpayer or the Government to have the right of appeal to the Tax Court (or the district court after payment and claim for refund).

Two correspondents suggested a pretrial arbitration procedure, to clarify the issues and perhaps effect out-of-court settlements.

Two correspondents suggested the establishment of a "public defender" in each locality to advise small taxpayers and, in special cases, to represent them before the Tax Court.

A more far-reaching proposal is the suggestion that the Tax Court should be converted into a tax division of the United States district court. The district court judge assigned to the tax division would then be in a position to hear jury and nonjury cases without requiring the taxpayer to pay his tax and file claim for refund as a condition precedent to litigating his claim. Organizationwise, this proposal would provide for a chief justice of the tax division sitting in Washington but with the district court judges permanently assigned to the 10 circuits. Appeal would lie, as in the usual district court case, to the appeal court of the circuit in which the case was originally heard. In support of this proposal, it is contended that the Tax Court as presently constituted is too close an adjunct to the Bureau to serve impartially as a final arbiter of the facts and law. It is also claimed that such a proposal would save travel expenses and would permit the taxpayer to have his case heard, either in a jury or nonjury proceeding, by an independent judiciary. As a corollary of this same proposal, it is suggested that an independent Board, comprised of accountants, should be constituted outside the Bureau for the purpose of settling cases and hearing evidence. This Board could determine any factual disputes and settle the case if both parties agreed. On disagreement, the Board would make written findings of fact, but not of law, which would be prima facie evidence of the facts in any future litigation in the district court, the findings being rebuttable by either party. Proceedings before the Board would be handled by accountants whereas any litigation would be handled by lawyers. In support of this recommendation for a factfinding board, it is argued that the factfinding and court functions should be separated so that the taxpayer could have his day in court rather than before a quasi-judicial body. It is also argued that the proposal would release Bureau personnel engaged in settlement work for investigative work instead.

3. Court procedure

Under present law a proposed deficiency may be contested in the Tax Court without payment of the disputed amount; but if the taxpayer wishes his contentions decided by a United States district court he must pay the amount in dispute, file claim for refund, and then

sue if his claim is rejected. Several correspondents urged that the district courts be available to decide whether there is a deficiency, as in the Tax Court, without payment of the disputed amount.

Another aspect of the Tax Court procedure that has been mentioned in the correspondence has been the practice of classifying Tax Court decisions as either (1) regular decisions or (2) memorandum decisions. Two objections have been leveled at the Tax Court's methods of printing its decisions. First, it is contended that all Tax Court decisions should be regular decisions and should be published officially. In support of this proposal it is argued that in practical effect a memorandum decision carries as much weight and importance as a regular decision and thus no differentiation should be made. Secondly, it is contended that the present method of printing the Tax Court regular decisions involves duplication and waste. The regular decisions are issued first as advanced sheets and then subsequently issued in book form with page and volume number. Under present practice the advance sheet opinions are not issued in the chronological order in which they subsequently appear in the bound volumes. This practice, it is said, results in unnecessary duplication and inconvenience both to taxpayers and to the Government. It is proposed that the advance sheets should be published in the same manner they will subsequently appear in the bound volume, together with page numbers, so that the advanced sheets could be bound without further composition or rearrangement.

On the question of appeals from decisions of the Tax Court, it has been suggested that no Tax Court determinations should be final and that the taxpayer should have the right of appeal from the Tax Court decision in every case. The present provisions of section 732 of the code, making the Tax Court's determination final in excess-profits relief cases has been especially criticized.

Other correspondents have suggested that decisions of the Tax Court and of lower Federal courts should be binding upon the Government within 30 days after the decision is rendered unless appeal is applied for and perfected in the usual manner.

At present a suit for the refund of tax overpaid must be against the collector (director) who collected the tax, or his personal representative, if the amount involved is more than $10,000 or if the taxpayer wishes a jury trial. Such a suit must be brought in the district in which the collector (director) resides. If the taxpayer wishes to bring suit in his own district, he can do so only if the amount is less than $10,000, unless the collector (director) who collected the tax has died. In either case the suit must be against the United States, without a jury. Suit against the United States, for any amount, may also be brought in the Court of Claims, without a jury. Some correspondents contend that these restrictions work a hardship on taxpayers who may live, for instance, in the eastern or western districts of Tennessee while the director resides at Nashville, in the middle district. It is suggested that taxpayers be permitted to sue the United States in their own districts, whether or not the amount is over $10,000; and that in such cases, as in suits against the collector (director), a jury should be permitted.

One correspondent urges that "tax disputes involving less than $5,000 be handled by the State courts"; that the taxpayer should not have to go any further than the county courthouse to get a fair

and impartial hearing. Another suggests that there should be a statutory prohibition against retroactive assessments based on court decisions.

In order to appeal to the Tax Court, the taxpayer has a 90-day period from the time that he receives his 90-day letter. The law makes the 90-day period a requirement for the Tax Court jurisdiction and this time period cannot be waived no matter what the reason may be for the taxpayer's failure to file his petition on time. This can and has resulted in harsh and unfair tax burdens upon the taxpayers for reasons based on form rather than substance. It is recommended that the various judges of the Tax Court be given the discretionary authority to extend the 90-day period for an additional 30-day period for such reasons as failure of the mail, illness of the taxpayer, and such other bases as the judges, in their discretion, believe merit an extension of time.

4. The Commissioner's refusal to follow adverse court decisions

Many correspondents deplored the fact that in many cases the Commissioner has refused to follow one or more decisions by the Tax Court or the district or circuit courts in favor of taxpayers, thus requiring all other taxpayers similarly circumstanced either to pay deficiencies which were unjustly asserted or subject themselves to needless expenses of litigation. Several referred to the fact that, with respect to the deductibility of payments of amounts in excess of OPA ceilings, not until there had been some 20 decisions adverse to his views, including circuit court decisions of 4 separate circuits, would the Commissioner yield on this point. One correspondent conceded that the taxpayer could pay the tax and file a claim for refund, hoping that before the statutory period had expired the Supreme Court would have decided the question.

Such an attitude is viewed as "plain cussedness" when the issue is such that only small amounts are involved, as in the alleged nondeductibility of State cigarette taxes, where the tax in controversy cannot exceed \$5 or \$10, or in the case of the alleged nondeductibility of travel expenses not involving overnight stays away from home, which usually involve small amounts of tax. Although the Tax Court in each case has decided in favor of the particular taxpayer, all other taxpayers are nevertheless denied the deductions, because the Commissioner will not acquiesce in these decisions, and it is not worthwhile for others to incur litigation expenses over small amounts.

Although the evil is deplored, suggested remedies are varied and some have been recognized by their proponents as being of doubtful practicability. Some extremists contend that the Commissioner should be compelled to follow any adverse court decision. Many contend that the Commissioner should be compelled to follow every court decision which is not appealed. The implication is that if a Tax Court or district court decision is appealed to a circuit court, a decision of that court adverse to the Commissioner should be accepted unless certiorari to the Supreme Court is applied for and accepted.

A few correspondents, recognizing the difficulties, suggested that the Commissioner be compelled to follow a decision of a circuit court (but not a lower court) "unless and until" it was reversed by a decision of the Supreme Court. One suggested that the Commissioner should be compelled to concede the question after there had been 3 adverse

decisions (of any courts), while another suggested that adverse decisions by 2 circuit courts or 1 circuit court and the Court of Claims should compel acquiesence. Yet another believed that forced acquiescence should only occur when there have been a "number" of decisions against the Commissioner.

C. ACCOUNTING PROBLEMS

1. Methods of accounting

Present law provides that net income is to be computed in accordance with the method of accounting regularly employed by the taxpayer unless the Commissioner determines that such method does not clearly reflect income. Income must be reported for the year in which received unless the approved method of accounting employed by the taxpayer requires reporting in a different period. Deductions and credits must be taken in the year when paid or incurred depending upon the method of accounting employed unless they must be taken in a different period to clearly reflect income.

In general, the accepted methods of accounting are the cash basis and the accrual basis. The regulations also approve use of the long-term contract method of accounting where appropriate and the present law specifically provides for optional use of the installment basis in reporting gain from installment sales.

The regulations also provide that the accrual method is deemed to be the only method that clearly reflects income if the taxpayers' business involves the use of inventories. Also, income is deemed to be constructively received by a taxpayer if it is credited to or set apart for him without restriction. A taxpayer may not change his method of accounting for tax purposes unless he secures the consent of the Commissioner.

Many persons contend that the provision of section 41 of the code, that—

> net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of the taxpayer—

has been nullified in many respects as the result of administrative rulings and court decisions. It is contended that income received for services to be performed in the future should be accounted for ratably as the services are performed, and that taxes should be deductible during the periods for which they are levied, yet present rulings and decisions do not permit this.

Similarly, it is urged that prepaid income, such as advance rent, should not be required to be included in income in the year of receipt but should be deferred until earned. Also, accruals should not be limited to deduction in the year in which the amount and liability become fixed. In proper cases the accruals should be deducted ratably over the period in which the income, for which they were incurred, will be earned. It is argued that where liabilities have been incurred, as for taxes or damages for personal injuries, etc., but the amount may be in dispute, taxpayers should be allowed to deduct estimated amounts in the year the liability was incurred, not in a later year when the amount was finally determined, and that, in general, deductions be allowed for periods when good accounting principles require their deduction.

A purchaser of real property is frequently required to capitalize taxes which he pays on the theory that the taxes are a liability of the seller which accrued before the sale. It is recommended that the taxes instead should be apportioned between seller and purchaser in accordance with local practice or statute.

Estimated expenses and losses, such as cash discounts and guaranty expenses, may not be deducted even though their probable amount is ascertainable from previous experience. It is proposed that such estimated expenses should be made allowable deductions.

Under Supreme Court decisions, where a taxpayer receives an amount of income in one year under a claim of right so that he can at that time use it as he wishes, the amount is taxable in the year of receipt even though he may subsequently be compelled to repay it to an adverse claimant (the amount so repaid being deductible in the year of repayment). In some cases, however, the taxpayer is subject to heavy taxes for the year of receipt and may have little or no income in the year of repayment against which to claim the deduction. It is suggested that whenever a taxpayer receives income under a mistake, which he must ultimately repay, a proper adjustment be made in the year of receipt, rather than a deduction in the year of repayment.

It is contended that taxpayers on the cash receipts and disbursements basis should be permitted to deduct payments for insurance, etc., in the year paid, even though the benefit extends over a longer period.

The doctrine of constructive receipt of income has evoked some complant. The Treasury Regulations provide that—

> Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. (Treasury Regulations 111, sec. 29.42–2)

It is contended that in applying the above regulation to certain life insurance options the Bureau has stretched the language to tax as income amounts which were not unqualifiedly subject to the taxpayer's control. The recommendation has been made that specific legislation should provide that the doctrine of constructive receipt will not apply to an election available to a life-insurance policyholder to commute installment payments and receive instead a lump-sum settlement, provided the policyholder must surrender valuable rights—such as the right to receive a fixed rate of interest on the balance of principal held by the insurer—in order to reduce the income to possession. A slightly different proposal along the same lines is the recommendation that the constructive receipt doctrine should be declared not applicable to a life insurance, endowment, or annuity contract where the proceeds are retained by the insurer under a settlement agreement with the taxpayer, provided the agreement is made not later than 60 days after the proceeds become available.

Where the taxpayer consistently keeps his books on that method a hybrid system, part accrual, as with respect to inventories or purchases and sales of goods, and part on the cash basis as respects expenses and miscellaneous income, should be permissible, according to one correspondent.

Another suggests that the taxpayer should be given the option to exclude fixed expenses from overhead in valuation of inventory without first obtaining permission from the Commissioner.

A correspondent suggests that, where one agency of the Federal Government, such as the Interstate Commerce Commission, requires the use of specific accounts and techniques, the Bureau of Internal Revenue, another agency of the Government, should be required to accept a return reporting income in accordance with those accounts and techniques as correct.

Another suggestion is that where returns on the cash basis have been made and accepted for many years any required change to the accrual basis should be prospective instead of retroactive.

A general suggestion made by a number of taxpayers is that the code should provide that tax accounting must conform to generally accepted accounting principles.

2. Installment sales

Under the present law dealers in personal property may elect to report gain therefrom on the installment basis. On the installment basis the proportion of each installment payment actually received which the total profit bears to the total sales price is includible in income.

The option to adopt the installment basis is also extended to sales of realty and casual sales of personalty exceeding $1,000 provided the initial payments (other than evidences of indebtedness) do not exceed 30 percent of the selling price.

On changing from the accrual to the installment basis the taxpayer must include in income in the year of change or subsequent years amounts received on account of sales in prior years.

The regulations provide that the installment basis may not be used where no payment is received in the year of sale.

It is suggested that the requirement of payment, however small, in the year of sale, which is imposed by present regulations, is unnecessarily restrictive and should be abolished, that is, require no payment in year of sale for qualifying for the installment basis.

The requirement that taxpayers changing from the accrual to the installment basis must include payments attributable to prior sales tends to impose a double tax on these receipts from prior sales and it is suggested that a limited credit be provided for taxpayers changing from accrual to installment basis, such credit being based on the tax attributable to the accrued income required to be currently included.

It is suggested that section 44 (d) be amended to allow an election to taxpayers on the installment basis who repossess a piece of real property within 2 years from sale providing the payments in this period are less than 10 percent.

Others recommend that the present provision that 30 percent downpayment is a determining factor between an installment sale and a cash sale should be eliminated on the theory that an installment sale

is rightly entitled to be designated as such irrespective of the down-payment. It is suggested in lieu thereof that a period of 1 year be used as a minimum in the formula for determining an installment sale rather than the present percentage.

3. Fiscal year provisions

When tax rate changes occur during a fiscal year, adjustment must be made for fiscal-year taxpayers thus affected. Section 108 of present law provides the formulas for making such adjustments by prorating the tax computed under both the old and new rates.

It has been suggested that the definition of a fiscal year should include annual accounting periods consisting of multiples of weeks as well as 12-month periods. Furthermore, provision should be made that income from partnerships and trusts should be taxed to individuals at the rates applicable when such income was earned. It has also been suggested that section 108 be amended to provide that substantive changes in the tax laws should be made effective on a calendar-year basis and that fiscal-year computations should be on a pro rata basis for the 2 calendar years involved.

Section 51 (b) (3) provides that a husband and wife cannot file a joint return if they have different taxable years. Thus, if an individual who makes his returns on a calendar-year basis marries a person who uses a fiscal year they cannot obtain the benefit of a joint return until one has obtained permission to change his accounting period and has filed a return for a short period. It is suggested that under such circumstances a joint return be permitted which will include the income of one spouse for a full year and the income of the other for a short period ending on the same day, with appropriate adjustments with respect to the short-period income.

One correspondent objects to the provisions of section 108 which provide that where rates change as of a certain date, fiscal year taxpayers with years ending after that date, compute 2 tentative taxes, at the 2 rates, and determine their tax on the basis of the time elapsed affected by each rate. He contends that where there is a rate change, or substantive changes, every fiscal-year taxpayer should compute his tax on the basis of rates and rules applicable to the preceding calendar year.

D. MISCELLANEOUS PROBLEMS

1. Data on returns

Two correspondents suggest that much time of taxpayers and Bureau personnel would be saved if dollar amounts only be required for all items on returns and supporting schedules.

Two correspondents advocated compulsory net-worth statements or balance sheets be required as a part of all returns of individuals, on the ground that this would lessen opportunities for fraud on the part of many persons who operate on a cash basis without books or bank accounts. Another would require taxpayers to report in each return the amount of cash and coupon bonds on hand. Another suggested that a profit and loss statement should take the place of filing a return.

A suggestion was made that, to eliminate in large measure the need for detailed examinations of taxpayers' records, taxpayers be permitted and encouraged, at their election, to file with their returns analyses of bank deposits and withdrawals.

Another suggestion was that amended returns should be required by law where the taxpayer subsequently learns that his original return was incorrect; that filing of an amended return showing a reduced tax liability be recognized as a claim for refund; and that amended returns in skeleton form, showing only the revised tax liability and such data and computations as would show the difference from the original return, be permitted.

One correspondent suggests that data required on supplementary schedules of the return form, such as capital gains and losses (Form 1040 C) and farm income (Form 1040 F) should be acceptable if filed on accountants' schedules or blank paper, instead of on the forms now required.

It has also been proposed that traveling expenses claimed by the taxpayer should be substantiated by automobile speedometer readings and when so substantiated should be accepted by the Bureau.

(A number of other suggestions were received concerning the forms used by the Bureau which are not included in this report as the staff will take these problems up directly with the Bureau and Treasury Department. These suggestions relate mainly to the style, size, and changes in the forms themselves.)

2. Interest on deficiencies and refunds

A considerable amount of correspondence related to interest charged on deficiencies. The most common complaint was that interest should not be charged where the period for assessment had been extended by a waiver. Most suggestions were that the interest charge should in all cases cease 3 years after the return was filed; one correspondent suggested that only a nominal rate be charged after that time; a few conceded that interest after the 3-year period would be proper where assessment within that period was prevented by taxpayer action or delays, or where, as in the case of pending litigation of the question at issue, delay in assessment is for the benefit of the taxpayer. Other correspondents believe that, whether or not the 3-year period has expired, interest charges are often, and inequitably, the result of Bureau delays—in making the examination, in preparing and typing the report, in reaching decisions. It is argued that interest should not be charged for periods of delay caused by the Government.

There were complaints that interest on deficiencies and interest allowed on refunds is computed by different methods, so that if an adjustment of a single transaction resulted in a deficiency for one year and a refund for another year, interest charged is relatively much greater than interest allowed. That is because interest on deficiencies runs from the due date of the return, but interest on the refund runs from the date the last payment was made. It is also stated that interest on deficiencies is payable immediately while interest on refunds is received much later. Further, it is stated that taxpayers frequently cannot ascertain how interest is computed, and it is suggested that the Bureau be required to furnish detailed interest computations.

It is argued that a rate of 6 percent is unrealistic under present conditions, and that the rate should be only 3 or 4 percent for both deficiencies and refunds.

One correspondent complained that interest is not ordinarily paid on tax overwithheld on wages. He believes that in such cases interest should be allowed at least from December 31, not beginning with April 15 of the following year, as at present.

Several correspondents propose that where a deficiency in tax for one year is eliminated by the carryback of a net operating loss from a subsequent year there should be no interest charged on the unreal deficiency.

3. Penalties

Several correspondents dealt with penalties, but with dissimilar approaches. One contends that fraud penalties are too great since they are often "in excess of the taxpayer's income." He maintains that the penalty should be on the tax evaded, and not on the entire deficiency. He also believes the penalties with respect to declarations of estimated tax are unreasonable. Another believes that the fraud penalty should be greater than 50 percent, and that the penalty for deliberate understatement of estimated tax should be greater, with relief where the understatement was not deliberate.

Another correspondent suggests that in some cases the penalties provided are too drastic, in others too lenient. He suggests "a graduated set of penalties with an overall ceiling"—for example, 10 percent for negligence (5 percent is too low), 10 percent for failure to keep proper books and records, 20 percent for failure to file a return, and 50 percent (with none of the other penalties) for fraud. Another suggests that the fraud penalty should be reduced where there have been no previous examinations of the taxpayer's returns, so that he has not been put on notice of what is expected.

4. Jeopardy assessments, liens, distraint, etc.

Several situations apparently involving undue hardships resulting from collection procedures were presented. It is argued that the law gives the Commissioner the right to "work devastating financial hardship upon a taxpayer by making a jeopardy assessment in an amount which is exorbitant" and then refusing to accept a bond for less than double this large amount. An instance cited is a jeopardy assessment levied against an individual as the alleged transferee of another individual. In spite of the fact that the Commissioner must prove liability as transferee and that the tax liability of the original taxpayer is in dispute, it is alleged that the transferee may be ruined even though the courts may ultimately decide that the asserted deficiency was grossly overstated or that there was no transferee liability. Another correspondent cited a case involving a possible criminal action against a taxpayer with an asserted transferee liability against his father. It is stated that all of the property of the father is tied up by liens, that he has no way even to pay taxes and insurance on the properties. The case has already been in the Tax Court for over a year, it may be months or years before the Government decides what to do as to criminal prosecution of the son, and it is alleged that local officials will not even accept a bond as provided under section 3673.

Another correspondent maintains that the Government's powers of distraint, lien, and so forth, are too broad in that they permit seizure of life-insurance policies, homestead, pensions, and subsistence items, which are generally exempt under State laws. He, and others, state that section 3691 is obsolete, and that much broader exemptions, for a homestead, household equipment, and the means of livelihood, should be allowed. He argues that claims for taxes should be dischargeable in bankruptcy. He maintains that wives and children

should have greater protection. He argues that powers of garnishment should be defined to limit the garnishment to a portion of the wages; that a general distraint on the contents of a safe-deposit box, thus denying access, is contrary to the fourth amendment of the Constitution, and should be limited to specifically named items believed to be in the box.

On the other hand, another correspondent believes the law should be changed to overcome the effect of court decisions holding that the Commissioner cannot levy on the whole or any part of property held by husband and wife as tenants by the entirety to satisfy the tax liability of one of the spouses.

A number of taxpayers have proposed that the Commissioner should be given the power to abate a jeopardy assessment where he believes the assessment should not have been made or where jeopardy no longer exists. The Bureau presently takes the position that the provisions of present law which authorize the Commissioner to abate a jeopardy assessment to the extent that he believes the assessment to be excessive in amount have the effect of restricting the Commissioner's power to abate to that type of situation. This narrow construction, according to several correspondents, works a hardship where the jeopardy assessment should not have been made initially or jeopardy no longer exists.

It has also been suggested that in the case of jeopardy assessment, the taxpayer should be given an option to require that his case be placed at the top of the Tax Court's docket.

5. Closing agreements

One correspondent states, correctly, that while sections 3760 and 3761 provide for binding closing agreements and compromises, it is required that such agreements be approved by the Secretary of the Treasury, and in practice it is very difficult to obtain such an agreement finally determining the tax liability. He points out that after the tax liability in a case involving several issues has been agreed upon, on a compromise basis, the Appellate Division representative will usually require an informal agreement (Form 870) to pay the tax and not to file a claim for refund with respect to that year. The courts have dealt variously with such informal agreements, in many cases holding, however, either that the Commissioner is not thereby prevented from asserting a further deficiency, or that the taxpayer is nevertheless not estopped from pressing any claim. It is suggested that designated officers in each district be empowered to enter into closing agreements which will preclude any further deficiency assessment or claim for refund in the absence of fraud, and that such agreements be encouraged in all cases where an agreement on the tax liability has been reached.

Another suggestion is that, in cases such as liquidations, the value of the property to be distributed be ascertained in advance and a binding agreement as to the values to be used for tax purposes by the stockholder recipients be given by the Commissioner in advance of the transaction.

Where there has been a corporate reorganization and the successor corporation, many years later, sells a property acquired from the predecessor corporation, it sometimes happens that there is a dispute

as to whether the basis of the property then sold should be its fair market value at the time of the reorganization or the basis in the hands of the predecessor and, if so, what that basis was. To eliminate such disputes at a time when the facts cannot then be obtained, it is suggested that whenever there is an acquisition by one corporation of the properties of another the Bureau be required to determine within a reasonable time the basis for tax purposes of all properties so acquired, and that thereafter both the Bureau and the taxpayer be estopped from claiming different bases.

6. Transferees

One correspondent argues that no one should be required, as a transferee, to pay the tax liability of a transferor "unless there has been fraud, collusion, or willful misconduct of some type."

Under present law, if the original taxpayer has extended the period for making an assessment of a deficiency beyond the normal 3 years, a claim for refund is timely if filed within the extended period and 6 months thereafter; but if a transferee gives a similar waiver extending the period during which a deficiency may be assessed the transferee may not file an acceptable claim for refund during the period of extension. It is argued that such a claim should be deemed timely, as in the case of the original taxpayer.

Under present law as interpreted by the courts, if a transferee pays a deficiency of tax with respect to the transferor's liability, interest must be paid from the due date of the transferor's return to the date of payment of the tax, but the transferee is allowed to deduct as interest paid on indebtedness only that amount related to the period after the transfer. It is contended that the interest for the entire period should be deductible by the transferee.

It is argued that where the business of a transferor is continued by the transferee as the result of a tax-free transfer, all the rights and obligations of the transferor should move to the successor. Thus, rights elected by the transferor such as the amortization of bond premiums, the use of LIFO inventories, the installment sales method of accounting, the right to charge off intangible oil well drilling costs, etc., would also be available automatically to the successor. Also, the successor should stand in the shoes of the predecessor with respect to a net loss and unused credit carryovers, war losses and recoveries, recoveries of bad debts, etc.

7. Information returns

Two correspondents are disturbed because much interest earned on United States E-bonds and other bonds is not reported. One points out that "one of the largest disbursers of income," the United States Government, is not required to supply information returns. He suggests that all interest paid on Government bonds be reported to the Bureau of Internal Revenue. Another suggests that whenever any series E-bond is cashed the redeeming agency give to the recipient of the money a statement of the amount of interest involved and directions to report that amount on an income tax return.

Another taxpayer is concerned over the fact that much of the income of transient farm laborers is not reported. He points out that such wages are not subject to withholding, and an information report is not required unless the employee earns $600 or more, as the result

of which these laborers move on to another employer when they have earned nearly $600. He believes that some method should be devised to insure collection of tax in such cases. Another deplores the fact that domestic employees, especially those who work by the day, seldom pay income taxes.

Another correspondent feels that the requirement of section 147 (b) that information returns be filed with respect to the collection (for another) of interest or dividends from foreign sources in any amount is too stringent and involves too much work for too little return. He suggests a $600 minimum, as generally provided in section 147 (a).

8. Adequate records

Several correspondents maintain that conscientious taxpayers who keep adequate records are paying higher taxes than they should because others who do not keep good records pay less than their share. One advocates greater publicity and personal contacts on the part of the Bureau of Internal Revenue to alleviate this condition; others suggest that section 54 (a) and (b) be enforced, so that every person liable to tax shall be required to keep adequate records. One correspondent suggests a civil penalty of 10 percent for failure to keep adequate records.

One correspondent objects to the requirement of the regulations, section 29.54–1, that records shall be "retained so long as the contents thereof may become material in the administration of any internal revenue law." He suggests that after a reasonable time retention of books of account only, and destruction of the great mass of vouchers, checks, and other supporting records, be permitted.

9. Inconsistent positions

Section 3801 of the code is intended to produce equitable adjustments in cases where items of income or deductions are determined to be attributable to a year, or to a taxpayer, other than the year, or the taxpayer, with respect to which they were originally reported in returns. Some correspondents contend that this section should be revised and extended. One correspondent reported a case where (1) a corporation did not deduct depreciation for the years 1913 through 1936, yet this depreciation increased the gain for 1948 when the building was sold; and (2) during many years the stockholders received distributions ultimately held to have been out of capital but which they reported as dividends, yet their gain on liquidation of the corporation was increased by those amounts. It is argued that where the basis of property for determining gain or loss on a sale is reduced by prior depreciation allowable but not claimed, the tax attributable to the gain should be offset by the overpayment in prior years resulting from failure to deduct proper depreciation, and that in cases such as those of the stockholders referred to adjustment should be made for overpayments of tax with respect to amounts erroneously reported as dividends. Another correspondent suggests that equitable tax adjustments be made for bad debts and other deductions claimed in the wrong years.

10. Simplification of the law

Throughout the correspondence, in brief statements or carefully elaborated paragraphs, there occurred the reiterated suggestion that

"something should be done to arrest the fantastically growing complexity of the tax laws," and that the present code should be "generally revised, and simplified throughout," made more "understandable" to ordinary persons, since "there will never be a sufficient number of tax experts" to understand and apply such complicated provisions. One correspondent points to the enormous number of amendments, and suggests that present law be scrapped for a new law.

Although there is this widespread belief that, somehow, the law should be made simpler, there is little unanimity of opinion as to specific things which are wrong, or how to correct them. Nor is there agreement on objectives; whereas one correspondent asks that the law reflect "what is best for all," and that it not be confused by provisions designed to "punish or reward" small groups, another correspondent, while advocating improved phraseology, says "loopholes and inequities must be eliminated" and therefore the law must be "tortuous and involved" because simple phrases will not do this—"simplicity is not possible nor desirable."

Several correspondents complained of the excessive number of cross references; one referred to the present excess profits tax provisions as the "2-book law," because one copy is necessary for his main inquiry and the other to supply the constant cross references. One correspondent said each section should be complete in itself, with no cross references, even if it is necessary to repeat the language of one section in another.

One correspondent suggests that the language of the law could be improved by using shorter sentences; another suggests that the draftsmen create complexity by trying for "an absolute minimum of wordage."

One correspondent gives as an illustration of complexities which should be eliminated the various requirements which compel millions of corporate stockholders to adjust the basis of their stocks because of stock rights, stock dividends, and to use substitute bases because of gifts, inheritances, etc.

11. The legal effect of regulations

One correspondent says there appears to be wide acceptance of the view that regulations have the force of law. He believes that regulations should merely clarify a statute and illustrate its applications; not add to it or create something not enacted. He suggests some statement of the restricted force of regulations should appear in new legislation. Another correspondent objects to the view that reenactment of statutory provisions implies congressional approval of administrative regulations and rulings under the prior law; he suggests that if there is a restatement or recodification of the law there should be included—

> a provision plainly stating that no implication may be derived therefrom that legislative approval of administrative acts, regulations, rules, or procedure has been intended.

12. Refunds—changes in the law

A correspondent who cites the case of a taxpayer who received a 2-cent refund at a cost to her of 26 cents, to say nothing of the cost to the Government, suggests that tax refunds of less than $1 be prohibited.

It is suggested that present law, which makes the taxpayer's right to a refund of excise tax depend on whether he did not pass on the tax to his customers, should be repealed. It is argued that since the taxpayer cannot avoid payment of an excise tax because he did not pass on the tax to the customer he should not be denied a refund merely because he included the erroneous tax in his charge to the customer.

Although refunds of excise taxes are allowed where the customer returns the goods for refund, no refund of excise tax is allowed where the goods were sold on credit but the customer did not pay his debt. It is suggested that refund of excise tax be allowed where goods remain unpaid for after 2 years.

It is suggested that the principles of section 3779, which permits an extension of time for paying a tax if that tax is likely to be eliminated by a carryback, be extended so that if a revenue agent has determined that a refund is payable for any prior year payment of current tax liabilities be deferred while the agent's findings are being reviewed, so that the refund when finally determined can be offset against the current liability payment of which was deferred.

13. Dividends not paid out of earnings

Very great difficulties to the stockholders involved and to the Bureau of Internal Revenue occur when corporations pay dividends believed to be in part not out of earnings and profits accumulated since March 31, 1913, nor out of earnings of the current year. The recipients cannot tell what portion of such a dividend is taxable until the corporation's income for that and all preceding years has been determined for tax purposes, and frequently such final determination occurs many years after the dividends have been received. As an example, a corporation, on the basis of tentative conclusions of the Bureau of Internal Revenue, notified its stockholders in 1952 that estimated portions of dividends paid in 1949 were not out of earnings, and advised them to file claims for refunds. However, the exact percentages could not be determined until tentative figures for 1942–47 had finally been determined, which might take an additional period of years. The correct taxes of all the stockholders for 1949 could not be determined until not only the 1942–47 but the 1949 tax situation of the corporation had been finally determined. Where a corporation has a fiscal year and a deficit the stockholders who receive a dividend during the calendar year cannot determine whether, or to what extent, it is taxable until the earnings of the corporation, if any, for its current fiscal year are determined. In the latter case, it is suggested that stockholders be permitted to report their dividends in the next calendar year when the corporation's earnings will be known. No suggestions for dealing with situations involving undetermined prior years' earnings were made except that the Bureau should expedite final determination of earnings in such cases.

14. Payment of tobacco stamp taxes

Section 3656 prescribes that revenue stamps may be issued for certified, cashier's, or treasurer's checks of a bank, but not for uncertified checks of corporations. One large cigarette manufacturing company has to have its checks certified in New York for payment to the revenue officials in southern cities, with a 3 to 5-day lag between certification and payment. As the result, some $3,900,000 of its funds each

day are thus tied up, in effect depriving the taxpayer permanently of the use of that money. Although there are only about 40 cigarette factories these factories pay cigarette stamp taxes amounting to nearly $1.5 billion dollars annually, so that funds so tied up with respect to all 40 factories are very large. It is suggested that where the Commissioner has satisfied himself as to the credit standing of the manufacturer ordinary uncertified checks issued by the corporation be acceptable.

Another, and much more serious, financial detriment due to time lags arises from the fact that cigarette and other tobacco stamps must be affixed to the product prior to its removal from the factory, whereas reimbursement for the taxes is not received until the wholesaler pays for the cigarettes or other tobacco products, which may be 30, 60, or more days after the stamps were affixed. One large tobacco company states that therefore it must have at least $50,000,000 invested in tobacco stamps at all times. It is stated that the various States permit the payment for cigarette stamps to be deferred for considerable periods after their use. It is suggested that, if the manufacturer posts a bond or gives suitable security, payment for tobacco stamps be made on the 20th day of the following calendar month with respect to all stamps issued during a month.

15. 90-day letters

Section 272 provides that the Commissioner may not assess a deficiency of income taxes until 90 days after a letter stating the proposed deficiency has been mailed to the taxpayer by registered mail. It sometimes happens that the taxpayer does not receive such letters. Since the deficiencies will have been determined as the result of an examination by an employee of the Bureau it is suggested that the employee who made the examination deliver the assessment notice personally to the taxpayer or his representative.

16. Foreign tax credit with respect to Canadian dividends

Payments of dividends and interest on Canadian securities are subject to a 15-percent Canadian tax. This tax is deductible as a foreign tax credit but in order to obtain that credit under existing regulations taxpayers must prepare form 1116, which is time consuming and difficult for most taxpayers and is especially difficult for both the beneficiary and the trustee where the taxpayer is the beneficiary of a trust which received income from Canadian securities. Since the minimum rate of the United States personal income tax is well above 15 percent it is suggested that if the only foreign tax credit (as is usually the case) is with respect to the Canadian tax on the income from securities, the taxpayer be permitted to obtain this credit by a mere statement on the bottom of page 3 of the return that the credit is at the rate of 15 percent of the income from Canadian securities as itemized on the return.

17. Publication of names of individual taxpayers

It is stated that great numbers of individuals with substantial amounts of taxable income do not file returns, and that many others who do file returns claim exemptions for persons whom they do not support. To prevent fraud and to increase the revenues it is suggested that lists of all persons filing personal income-tax returns, together with the number of dependents claimed by each, be filed in the post offices in the localities where the taxpayers reside.

18. Statute of limitations—court decisions

It is contended that notwithstanding the statute of limitations, whenever by a final decision of a Federal court a long-established interpretation of the law has been changed, all taxpayers affected by the court decision should have the right to file claims for refund with respect to taxes illegally collected in accordance with the interpretation followed prior to the court decision.

One taxpayer suggested that if a taxpayer pays estimated tax and overlooks claiming the full amount of such payment on his final return the overlooked portion should not be construed as a payment of tax but it should be possible for the taxpayer to recover this regardless of the statute of limitation.

It has also been recommended that the statute should not be suspended unless the taxpayer is outside the jurisdiction of the United States.

The suggestion was made that a 6-year statute of limitations be provided where the failure to file a return is not due to fraud. It was also suggested that the Commissioner should be permitted by statute to abate or reduce penalties for failure to file a return.

The suggestion was also made that the 5-year period for assessment which is now applicable when gross income is understated by more than 25 percent should not be applied if the return provides adequate disclosure of the omitted item.

19. Single return for Federal and State taxes

To eliminate duplication of expenses by tax administrators and the filing of duplicate returns by taxpayers it is suggested that arrangements be made so that one return for both Federal and State taxes could be filed. Examination could be made by Federal officers and the State tax could be paid by the Federal Government to the State.

20. Review by the Joint Committee on Internal Revenue Taxation of proposed refunds

In many cases refunds in excess of $200,000 result from the carryback or carryover of net operating losses, excess profits credits, etc. It is suggested that review by the joint committee staff is unnecessary in such cases and that action on other refunds resulting from substantive adjustments would be expedited if such proposed refunds were not reviewed.

21. Combined withholding of income and social security taxes

Present law permits combined deductions for income taxes and old-age-security taxes withheld in cases where the annual salary is not in excess of $3,600. It is suggested that it would be very helpful to withholding companies if the limit of $3,600 were eliminated so that the two tax deductions would be combined for all income groups. This would be done in every case where the salary is in excess of $3,600 by withholding the proper proportion of the maximum old-age-security tax of $54 per year. Proper adjustments could be made in cases where the employee leaves before the end of the year.

22. Summons to produce records

Sections 3614 and 3615 give authority for directors of internal revenue and other officers or employees of the Bureau of Internal Revenue designated by the Commissioner to summon any person to appear be-

fore him and to produce books and records and to answer questions. It is stated that such powers are sometimes abused. One correspondent suggests that the power to issue such a summons should be entrusted to the courts alone, after a proper showing by the administrative officers of the necessity for such a summons. Another correspondent suggests a more specific provision in the law stating exactly which employees of the Treasury Department should have such powers.

23. Tax anticipation Treasury notes

One correspondent states that his company purchases United States Treasury savings notes and uses them to pay its installments of income tax. Previously these notes matured on the 1st day of the month, so that the return could be filed at any time between the 1st and 15th of the month. Recent notes mature on the 15th, however, and it is stated that if they are presented for payment prior to that date a month's interest must be forfeited. Consequently the corporation must wait until the 15th of the month to file its return and pay its tax installment. It is suggested that either the maturity date of these notes be changed back to the 1st of the month, or that taxpayers using such notes to pay taxes be given a few extra days, without penalties, to file returns.

24. Reserve for bad debts—Banks

Under a ruling of the Commissioner of Internal Revenue commercial banks are allowed to accumulate limited amounts of taxfree reserves for bad-debt losses on loans. The amount which can be deducted from taxable income in any year is determined by applying the ratio of losses to loans outstanding, and the reserve so built up may not exceed three times this ratio applied to current loans.

The following proposals have been received in this connection:

(1) Raise the ceiling on the reserve to five times the annual amount in order to permit banks to accumulate more adequate reserves.

(2) Increase the maximum reserve to 6 times the average annual loss based on a 20-year experience period, since for years after 1954 the ratio will be based on 20 years of minimum losses.

(3) Extend the bad-debt-reserve rule to finance corporations, using at least a 10-year experience period. At present there is wide divergence of allowable reserves in this field (1.61 to 10 percent).

(4) Increase the reserve allowance by using longer base period (25, 30, or 40 years) or compute the ceiling in some different manner.

(5) Limit amount put into the reserve for bad debts each year to 25 percent of net income for that year or the amount by which 10 percent of total deposits at the close of the year exceeds the sum of reserves, surplus, undivided profits, and capital accounts at the beginning of the tax year.

(6) Allow banks to add to their reserves for bad debts on the basis of their 20-year moving average experience without imposing a ceiling or maximum reserve.

APPENDIX

Appendix A

The following is the text of the questionnaire issued by the staff of the Joint Committee on Internal Revenue Taxation on July 21, 1952:

The staff of the Joint Committee on Internal Revenue Taxation is engaged at present in collecting and analyzing suggestions for improvements in the internal revenue laws and their administration. The objective of this study is to secure information which will improve the revenue system for the future.

It is believed that important suggestions for improving the internal revenue laws and administration may come from lawyers, accountants, engineers, teachers, and other groups or organizations familiar with tax problems. The businessman, the farmer, and the wage earner through the actual application of the tax law to their specific cases may also be in a position to point out complications, inequities, and hardships which they have experienced in the application and administration of the tax laws.

Communications of a wholly general nature will be of little practical value in this study. Improvements in specific provisions of the law and its administrative practice will be of great help. Complaints as to the complexity of the provisions of the Code and the time and effort required to understand and apply the particular section involved will also be of great value. Where practicable reference should be made to the title and sections of the Internal Revenue Code and the particular problem involved and the solution desired. Suggestions involving a fundamental change in the tax system will also be helpful and will receive careful examination and analysis by the staff. Defects in the present administrative practice, if any, particularly with reference to the promulgation of regulations, lack of uniformity of treatment in the application of the tax law, and difficulties in getting tax settlements, will also be of interest in connection with the staff study.

Suggestions should be mailed to the Joint Committee on Internal Revenue Taxation, Room 1011 New House Office Building, Washington, D. C., as promptly as possible.

The following are examples of problems you may have encountered in connection with the Federal tax laws. Your comments, including suggested solutions, on any of these problems would be appreciated, as well as your views on any other problems which you may have occasion to consider.

ILLUSTRATIVE INDIVIDUAL INCOME-TAX PROBLEMS

1. Are you having difficulties with the definition of dependents (sec. 25 (b) (3) of the Internal Revenue Code)? If so, explain your difficulty and how you desire the definition to be corrected.
2. Do you feel that the head-of-household provision (sec. 12 (c) of the Internal Revenue Code) solves the problem of single individuals with dependents? If not, what solution would you suggest? Have you any suggestions as to the tax treatment of single people without dependents?
3. Have you any suggestions as to the desirability of allowing for expense of child care and supervision in cases where the fathers and mothers or the widowed fathers or mothers are working?
4. Have you had any difficulty with respect to the tax treatment of board and lodging, with particular reference to whether the present application of the "convenience of the employer" rule furnishes an appropriate and workable test of taxability?

5. In the case of married people, do you feel that it would be better to have a separate rate schedule instead of requiring them to go through the mechanics of splitting their income? Explain your views fully.
6. What has been your experience as to the present practice of permiting deductions by employees for work clothes and traveling or entertainment expenses? If you are having difficulties with these provisions, what is your solution?
7. Are you having difficulties with the present treatment of capital gains and losses? If so, state the difficulty and suggested solution.
8. Do you feel that the present method of taxing estates and trusts can be simplified? If so, what solution do you suggest?
9. Have you any suggestions with respect to the requirement of declarations and the payment of estimated tax?
10. Have you any suggestions for revising the method of taxing partnerships and the reporting of partnership profits by individual partners?
11. Do you feel that the present rule for treatment of pensions and annuities is operating fairly? If not, what is your possible solution?
12. Have you any suggestions for providing and fostering individual incentive devices (e. g., treatment of gain from sale of patents in hands of inventor; expenses incurred by taxpayer for advanced study and training in his occupational field; profit-sharing plans; bonuses; overall rate limitation)?
13. Do you have any other problems and suggested solutions?

ILLUSTRATIVE CORPORATION AND OTHER BUSINESS TAX PROBLEMS

1. Section 102 surtax on improper accumulations of surplus (e. g., possible limitations on the area of application of tax; burden of proof; treatment of dividends paid shortly after close of taxable year).
2. Consolidated returns and intercorporate dividends (e. g., penalty and taxes imposed with respect to; compulsory consolidation of returns for closely affiliated corporations; elective consolidation of returns for less closely affiliated corporations).
3. Possible means of alleviating double taxation of dividends, consideration being given to the effect on the revenue.
4. The desirability of permitting small corporations the option of being taxed as partnerships and of permitting unincorporated businesses the option of being taxed as corporations.
5. Problems involved in the sale of all the stock or assets of a corporation.
6. Whether gain or loss on assets should be recognized to continuing partners upon the death or other withdrawal of another partner.
7. Inventories (e. g., problems involved in shifting from FIFO to LIFO).
T. Depreciation (e. g., present Bureau practices in allowance of depreciation; accelerated depreciation; declining balance depreciation; replacement cost depreciation; amortization).
9. Depletion.
10. Research and development expenditures (e. g., expensing rather than capitalizing).
11. Small, new, or expanding businesses—possible types of special treatment.
12. Excess profits tax:

    (*a*) Possible revisions of tax (e. g., base period, industry rates of return, new grounds for automatic relief) which might minimize need for legislative treatment of large number of individual relief problems.

    (*b*) Other—invested capital base, average earnings base, capital additions, determination of excess profits net income, public utility credit, etc.

13. Other problems and suggested solutions.

ILLUSTRATIVE EXCISE TAX PROBLEMS

1. Instances of discrimination between competing products or services.
2. Multiple taxation caused by application of two or more Federal excises.
3. Extent to which various excises enter into the cost of doing business.

4. Examples of imperfect operation of credit or refund devices.
5. Instances where it appears that the tax is applied to the wrong base.
6. Methods of improving equity of excise tax system as a whole or of individual excises.

ILLUSTRATIVE ADMINISTRATIVE PROBLEMS

1. Desirability of change from March 15 to April 15 of date for filing individual income tax returns and declarations, including the possibility of corresponding changes in the dates for paying second and third installments of estimated tax. (Effect of such a change on existing correlation with State filing dates.)
2. Problems involved in representation of taxpayers before the Treasury Department.
3. Return forms—possibility of simplification and clarification.
4. Difficulties encountered in substantiating deductions.
5. Review procedures—extent to which changes are necessary or desirable.
6. Regulations—whether they carry out the intent of Congress. Discuss actual situations.
7. Other problems and suggested solutions.

Appendix B

Percentage depletion data

Item	Percent					Year beginning after Dec. 31						Effective Jan. 1, 1951
	5	10	15	23	27½	1925	1931	1941	1942	1943	1946	
Aplite			X									X
Asbestos		X										X
Barite			X							X		
Bauxite			X								X	
Bentonite			X								X	
Beryl			X							X		
Borax			X									X
Bromine, from brine wells	X											X
Brucite		X										X
Calcium carbonates		X										X
Calcium chloride, from brine wells	X											X
Clam shell	X											X
Clay, ball			X					X				
Clay, brick and tile	X											X
Clay, china			X								X	
Clay, refractory and fire			X									X
Clay, sagger			X					X				
Coal	X						X					
Do		X										X
Diatomaceous earth			X									X
Dolomite		X										X
Feldspar			X							X		
Fluorspar			X					X				
Fullers earth			X									X
Garnet			X									X
Gilsonite			X								X	
Granite	X											X
Graphite, flake			X						X			
Gravel	X											X
Lepidolite			X							X		
Limestone, chemical grade			X									X
Limestone, metallurgical grade			X									X
Magnesite		X										X
Magnesium carbonates		X										X
Magnesium chloride, from brine wells	X											X
Marble	X											X
Metal mines			X				X					
Mica			X							X		
Oil and gas wells					X	X						
Oyster shell	X											X
Perlite		X										X
Phosphate rock			X								X	
Potash			X							X		
Pumice	X											X
Pyrophyllite			X								X	
Quartzite			X									X
Rock asphalt			X					X				
Sand	X											X
Scoria	X											X
Shale	X											X
Slate	X											X
Sodium chloride	X											X
Spodumene			X							X		
Stone	X											X
Sulphur				X			X					
Talc			X							X		
Thenardite			X								X	
Tripoli			X									X
Trona			X								X	
Vermiculite			X							X		
Wollastonite		X										X